

Michigan Law Review

Volume 73 | Issue 2

1974

Competition and Regulation in the Stock Markets

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COMPETITION AND REGULATION IN THE STOCK MARKETS

Robert Pozen

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COMPETITION AND REGULATION IN THE STOCK MARKETS

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THERE are two main types of stock markets in the United States: exchanges¹ and the over-the-counter market (OTC).² An exchange is a centralized marketplace in which a limited number of

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Research assistance for this article was provided by Ronald Janis and Harvey Levin. Useful insights were contributed by Professors Tom Krattenmaker, Robert Pitosky, Paul Posner, and Roy Schotland. Helpful comments were received from Mr. Alton Harris, Senate Subcommittee on Securities; Mr. Barry Levine, SEC Branch Chief; Mr. V. Reed Manning, Mitre Corporation; and Mr. Timothy Hardy, Member of the Ohio Bar.

This article incorporates legislative, administrative, and judicial developments through January 31, 1975.

1. The New York Stock Exchange (NYSE) is the largest American stock exchange. While it lists the stocks of only one tenth of one per cent of the companies in the United States, the 1,399 corporations it listed in 1971 owned 38.8 per cent of the total assets, accounted for 43.4 per cent of the total sales or revenues, and earned 95.5 per cent of the total net income of all American companies. NYSE, 1974 FACT BOOK 34 [hereinafter NYSE FACT BOOK].

The American Stock Exchange (AMEX), also located in New York City, complements rather than competes with the NYSE. Because most of the members of the AMEX are also members of the NYSE, and because the NYSE forbids its members to join any other exchange in New York City that trades NYSE-listed stocks, the AMEX is effectively prevented from competing with the NYSE. See SUBCOMM. ON SECURITIES OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SECURITIES INDUSTRY STUDY, S. Doc. No. 93-13, 93d Cong., 1st Sess. 90-91 (1973) [hereinafter SENATE STUDY]. AMEX listed 1,419 issues in 1972, although each year a significant number of stocks "move up" to the NYSE from the AMEX. In the five years prior to 1972, for example, 178 issues moved from the AMEX to the NYSE. AMEX DATABOOK 20, 22 (1973).

In terms of number of shares and dollar volume, the AMEX has traditionally rated second among registered exchanges. However, in 1973 the dollar volume of trading on the AMEX dropped precipitously to 5.9 per cent of the total exchange dollar volume. NYSE FACT BOOK, *supra*, at 17. By September 1974, both the Midwest and Pacific Coast Stock Exchanges were recording higher dollar volume trading than the AMEX. 33 SEC STAT. BULL. 1015 (1974). Furthermore, the over-the-counter market (OTC) share volume was almost double that of the AMEX in 1972, 39 SEC ANN. REP. 154 (1973), and in 1973 the dollar volume on the OTC for only NYSE-listed stocks was about the same as the total AMEX dollar volume. 33 STAT. BULL. 334, 705 (1974).

In 1973 there were 10 active regional stock exchanges. These exchanges are listed below, with 1973 dollar volume and share volume in stocks. NYSE and AMEX volumes are listed at the bottom for comparison.

Stock Exchange	Dollar Value (in thousands)	Share Volume (in thousands)
Boston Stock Exchange	1,792,908	42,171
Cincinnati Stock Exchange	118,849	2,838
Detroit Stock Exchange	380,532	10,676
Midwest Stock Exchange	8,131,114	241,484
National Stock Exchange	23,896	7,462
Pacific Coast Stock Exchange	6,315,636	206,234

members³ trade certain "listed" securities.⁴ In contrast, the OTC is

Stock Exchanges	Dollar Value (in thousands)	Share Volume (in thousands)
PBW Stock Exchange	4,386,341	126,991
Intermountain Stock Exchange	996	2,262
Spokane Stock Exchange	6,685	13,031
Honolulu Stock Exchange	1,897	260
NYSE	146,450,834	4,336,581
AMEX	10,429,640	740,358

33 SEC STAT. BULL. 334 (1974).

In 1963 the SEC estimated that trading in NYSE- and AMEX-listed stocks accounted for an average of 93 per cent of the total dollar volume of trades on the major regional exchanges. In terms of share volume, the SEC estimated that trading in NYSE- and AMEX-listed stocks accounted for between 48 and 97 per cent of the regional total. SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. 95, 88th Cong., 1st Sess., pt. 2, at 930, 1084 (1963) [hereinafter SPECIAL STUDY]. Recent statistics show that a significant portion of the volume of NYSE-listed shares is now being traded on the regionals. In the first quarter of 1974, for instance, 18 per cent of all trades in 50 selected NYSE issues was effected on regionals. 33 SEC STAT. BULL. 706 (1974).

For a general discussion of how exchanges work, see SPECIAL STUDY, *supra*, at 5-532; Wolfson, Rosenblum & Russo, *The Securities Markets: An Overview*, 16 HOWARD L.J. 791, 810-21 (1971).

2. The OTC handles about 20,000 stocks not listed on any exchange. *Hearings on the Securities Industry Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 2d Sess., pt. 7, at 3562 (1972) [hereinafter *House Hearings*]. However, OTC trades in NYSE-listed stocks—"third market" trades—have been increasing rapidly. In 1972 the third market traded 327 million shares worth \$13.6 billion. Between 1965 and 1972, third-market trades as a proportion of NYSE trades in the same stocks increased from 2.7 to 7.3 per cent measured by share volume and from 3.4 to 8.5 per cent measured by dollar volume. 39 SEC ANN. REP. 157 (1973).

For a general discussion of the OTC, see I. FRIEND, G. HOFFMAN & W. WINN, *THE OVER-THE-COUNTER SECURITIES MARKETS* (1958); SPECIAL STUDY, *supra* note 1, at 533-796.

3. The number of members of an exchange is limited by its constitution. See, e.g., NYSE Const. art. IX, § 1, 2 CCH NYSE GUIDE ¶ 1401 (1974) (1,366 members); AMEX Const. art. IV, § 1(a)(1), 2 CCH AMEX GUIDE ¶ 9031 (1972); Pac. Stock Exch. Const. art. V, § 1 (1973) (220 members); Midwest Stock Exch. Const. art. II, § 1 (1973) (465 members).

Membership rights on exchanges—so-called "seats"—are traded, subject to approval by the governing board. For example, 158 NYSE seats were transferred in 1973; cash prices paid for these seats ranged from \$190,000 to \$72,000. The highest price paid for an NYSE seat since 1934 was \$515,000 in 1969, while the lowest was \$17,000 in 1942. NYSE FACT BOOK, *supra* note 1, at 59.

4. In order to have its stock traded, a corporation must be "listed" with the exchange. Each exchange takes into account the number of publicly held shares available for trading, the value of the shares, and the earnings power or assets of the corporation in determining whether to list a corporation's securities. For example, the NYSE requires, *inter alia*, that a corporation have 1 million publicly held shares, 2,000 or more holders of 100 or more shares, and that the value of the publicly held common stock be at least \$16 million. NYSE FACT BOOK, *supra* note 1, at 30-31. The listing requirements for most exchanges are contained in the exchange constitution or rules. See, e.g., MIDWEST STOCK EXCH. RULE 8 (1973). Stocks listed on one exchange may be traded on other exchanges if "unlisted trading privileges" are extended by the SEC. SENATE STUDY, *supra* note 1, at 129-33.

a network of telephone lines and a computerized quotation system⁵ through which broker-dealers can trade in any stock.⁶

Both types of stock markets are supervised by self-regulatory organizations (SRO's) in cooperation with the Securities and Exchange Commission (SEC).⁷ An SRO is composed of brokers⁸ from a particular stock market; its primary responsibilities are protecting investors and maintaining orderly trading. Every exchange is an SRO for its own marketplace,⁹ while the National Association of Securities Dealers (NASD) is the sole SRO for the over-the-counter market.¹⁰ The SEC has several checks on the regulatory performance

5. Prior to 1971, the OTC was a network of telephone communications together with daily sheets listing the "bid" and "asked" prices for OTC stocks. On February 8, 1971, the National Association of Securities Dealers (NASD) initiated a centralized and automated quotation system called NASDAQ, which displays up-to-the-minute quotations on listed stocks at terminals in subscribers' offices. Actual transactions must still take place over the telephone, however. See SENATE STUDY, *supra* note 1, at 89-90. In 1972, NASDAQ reported share volume information for the 3,500 most active OTC issues; volume was 2.2 billion shares. In the future, NASDAQ may report its statistics in terms of dollar volume. 39 SEC ANN. REP. 55 n.9, 154 (1973).

6. This is not true for NASDAQ: "To be eligible for inclusion in NASDAQ, a security must meet the requirements for registration under the Securities Exchange Act of 1934 (*i.e.*, it must be issued by a company with at least \$1,000,000 in assets and 500 shareholders), and must have at least two dealers making a market in it. To enter quotes for a security in NASDAQ, a dealer must register as a market maker (with NASD)" SENATE STUDY, *supra* note 1, at 90 n.5.

7. SPECIAL STUDY, *supra* note 1, pt. 4, ch. XII, at 495-957; Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROB. 663, 667-77 (1964).

The two-tiered SEC-SRO regulatory system is often referred to as "cooperative regulation," a term first introduced in 1938. SENATE STUDY, *supra* note 1, at 144; SUBCOMM. ON COMMERCE AND FINANCE OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, SECURITIES INDUSTRY STUDY, H.R. REP. NO. 92-1519, 92d Cong., 2d Sess. 79-116 (1972) [hereinafter HOUSE STUDY].

8. For purposes of this article, the term "brokers" includes broker-dealers.

9. Securities Exchange Act of 1934, § 6, 15 U.S.C. § 78f(d) (1970), empowers the SEC to register securities exchanges if they meet certain standards for self-regulatory activities. Under section 5 of the 1934 Act, 15 U.S.C. § 78e (1970), an exchange must be registered for a broker-dealer legally to trade on it, unless the SEC exempts the exchange from registration because of limited trading volume. Thirteen exchanges were registered with the SEC in mid-1973. Eleven registered exchanges, plus one exempted exchange (the Honolulu exchange), are listed in note 1 *supra*. The other two registered exchanges are the Chicago Board of Trade and the Chicago Board Options Exchange, neither of which actively trades common stocks. 39 SEC ANN. REP. 10, 51, 154 (1973).

10. The NASD is the only registered "national securities association" under Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 78o-3 (1970). Section 15A does not require a single SRO for the OTC market, but the NASD is the only one that came into existence. The NASD is a voluntary association, which, as of June 1973, had 3,884 members. 39 SEC ANN. REP. 54, 61, 63 n.23 (1973).

Any broker-dealer who trades in the OTC and is not an NASD member must be subject to direct regulation by the SEC under section 15 of the 1934 Act, 15 U.S.C. § 78o (1970). Those broker-dealers who do not join the NASD are referred to as SECO broker-dealers, a label derived from the additional forms that they must file with the SEC. As of June 1973, there were 276 SECO broker-dealers. 39 SEC ANN. REP. 61 (1973).

of SRO's. All SRO's must file registration statements with the SEC, which can deregister SRO's on certain grounds.¹¹ The SEC is given considerable power to alter or supplement exchange rules;¹² new rules¹³ and disciplinary decisions¹⁴ of the NASD are subject to review by the Commission. The SEC is also authorized to make rules di-

11. The use of any facility of an unregistered exchange to effect a securities transaction is illegal. Securities Exchange Act of 1934, § 5, 15 U.S.C. § 78e (1970). The SEC may deregister an exchange "if the Commission finds that such exchange has violated any provision of this title or of the rules and regulations thereunder or has failed to enforce, so far as is within its power, compliance therewith by a member or by an issuer of a security registered thereon." Securities Exchange Act of 1934, § 19(a)(1), 15 U.S.C. § 78s(a)(1) (1970). The SEC has used this authority only once. *See* San Francisco Mining Exch. v. SEC, 378 F.2d 162 (9th Cir. 1967).

12. Securities Exchange Act of 1934, § 19(b), 15 U.S.C. § 78s(b) (1970), empowers the SEC to alter or supplement exchange rules

in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters.

By way of comparison, under Securities Exchange Act of 1934, § 15A(k)(2), 15 U.S.C. § 78o-3(k)(2) (1970), the SEC may alter or supplement NASD rules in four procedural areas:

(A) the basis for, and procedure in connection with, the denial of membership or the barring from being associated with a member or the disciplining of members or persons associated with members, or the qualifications required for members or natural persons associated with members or any class thereof.

(B) the method for adoption of any change in or addition to the rules of the association.

(C) the method of choosing officers and directors.

(D) affiliation between registered securities associations.

The SEC is also empowered under section 15A(1) to abrogate any rule of the NASD if such action "is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purposes of this chapter."

13. Securities Exchange Act of 1934, § 15A(j), 15 U.S.C. § 78o-3(j) (1970), requires the NASD to file "any changes in or additions to" its rules with the SEC before such changes or additions become effective, and the SEC is empowered to disapprove any such changes or additions within 30 days after the new rule is proposed. By comparison, exchanges need only provide the SEC with rule changes "forthwith upon their adoption." Securities Exchange Act of 1934, § 6(a)(4), 15 U.S.C. § 78f(a)(4) (1970). The SEC has no "approval" power over new exchange rules as such. It may require that new rules be altered or supplemented, but only if the rules fall into one of the substantive categories enumerated in section 19(b). *See* note 12 *supra*.

14. NASD disciplinary proceedings are subject to review by the SEC, either upon the Commission's own motion or upon application of an aggrieved party. Securities Exchange Act of 1934, § 15A(g), 15 U.S.C. § 78o-3(g) (1970). The SEC has no comparable power over exchange disciplinary proceedings.

rectly for all stock markets on designated topics, such as market manipulation.¹⁵

Within the next decade, this regulatory framework, as well as the economic structure of American stock markets, will change dramatically. After years of minimum commission rates fixed by the New York Stock Exchange (NYSE), the SEC has slated the start of negotiated public rates for mid-1975.¹⁶ While stock trading is now fragmented into multiple markets,¹⁷ the SEC has promulgated a blueprint for a central market utilizing advanced computer technology.¹⁸ In its past session, the Senate approved major securities legislation, which has a high probability of passage in the next Congress.¹⁹ For the first time in over a decade, the Supreme Court has agreed to review an antitrust claim against a stock exchange.²⁰

15. Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1970).

16. SEC Securities Exchange Act Release No. 11073 (Oct. 24, 1974), [Current] CCH FED. SEC. L. REP. ¶ 79,991. (Proposed rule 19b-3, which requires all exchanges to eliminate fixed commissions by May 1, 1975); SEC Securities Exchange Act Release No. 11203 (Jan. 23, 1975), [Current] CCH FED. SEC. L. REP. ¶ 80,067. Fixed commission rates on that portion of orders above \$300,000 have already been eliminated. 39 SEC ANN. REP. 7 (1973). Both the NYSE and the AMEX have experimentally gone to negotiated commissions on transactions below \$2,000. See *NYSE Moves One Step Closer to Elimination of Fixed Rates*, BNA SEC. REG. & L. REP. No. 239, at A-4 (Feb. 13, 1974); *AMEX Follows NYSE Lead; No Fixed Rates on Small Orders*, BNA SEC. REG. & L. REP. No. 240, at A-9 (Feb. 20, 1974). For a critique of the fixed commission system, see Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675 (1970).

17. Except for the complementary relationship between the NYSE and the AMEX, see note 1 *supra*, all of the exchanges and part of the OTC trade largely the same stocks, but the NYSE, the regionals, and the OTC are separate markets in terms of information and transaction flow. See SENATE STUDY, *supra* note 1, at 57-58.

18. See, e.g., SEC, Policy Statement on a Central Market System (March 29, 1973) [hereinafter SEC Policy Statement]; Statement of the Securities and Exchange Commission on the Future of the Securities Markets, in [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 74,811, at 65,612 (Feb. 2, 1972) [hereinafter SEC Statement on Future Market Structure].

19. In the second session of the Ninety-third Congress, the Senate passed The National Market System Act of 1974, S. 2519; The Stockholders Investment Act of 1973, S. 2842; and The Securities Processing Act of 1973, S. 2058. See also An Act To Amend the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, S. 470, 93d Cong., 1st Sess. (1973). S. 2519, S. 470, and S. 2058 have since been incorporated into Securities Acts Amendments of 1975, S. 249, 94th Cong., 1st Sess. (1975). (All citations to proposed legislation in this article will be to S. 249, unless otherwise indicated.)

The House had before it an omnibus bill that included most of the areas covered by the Senate legislation. See The Securities Exchange Act Amendments of 1973, H.R. 5050, 93d Cong., 2d Sess. (1974). Although this bill was passed by the House Commerce Committee by a vote of thirty-nine to one, it did not receive a rule from the House Rules Committee in two attempts during the lameduck session. The first negative vote of the Rules Committee was attributed to intense lobbying by the stock exchanges and the Securities Investors Association, as well as reluctance to pass major legislation in a lameduck session. Wall St. J., Nov. 27, 1974, at 2, cols. 2-3 (midwest ed.). The second vote of the Rules Committee, a tie, was attributed to the inability of the committee chairman to bring the issue to a vote in the early afternoon, and to the

This article analyzes the proposed stock market reforms in light of the inherent tension between two important governmental functions—promotion of a competitive economy under the antitrust laws²¹ and regulation of stock transactions under the Securities Exchange Act of 1934.²² Conflicts between these two public policies are often difficult to resolve. For example, suppose an exchange has only one specialist in a certain stock and rejects a second on the ground of inadequate capitalization.²³ This would reduce the potential for competitive bids on orders for the stock and give rise to a colorable antitrust claim. Yet the exchange's decision might be a justifiable attempt to solve the chronic problems caused by under-capitalized specialists.

Part I of this article suggests that the courts have not satisfactorily resolved the tension between competition and regulation in the stock markets, and that the proposed legislation would in fact aggravate that tension. Part II uses an economic model of stock transactions to derive an alternative approach for reconciling competitive and regulatory considerations. Part III applies this approach to several key governmental decisions in the transition from fixed commission rates to the central market system.²⁴

dental appointment of one key representative. N.Y. Times, Dec. 4, 1974, at 61, cols. 7-8, 66, cols. 2-5 (city ed.). H.R. 5050 has been reintroduced in the current Congress as H.R. 10, 94th Cong., 1st Sess. (1975). It is given an excellent chance of passage in this session because Congress is significantly more liberal. See Remarks of Rep. John E. Moss (D-Cal.), Chairman of the House Subcommittee on Commerce and Finance (which sponsored the securities legislation), reported in BNA SEC. REG. & L. REP. No. 279, at AA-1, -2 (Nov. 27, 1974).

For a general overview of the proposed legislation, see Painter, *An Analysis of Recent Proposals for Reform of Federal Securities Legislation*, 71 MICH. L. REV. 1576 (1973).

20. *Gordon v. NYSE*, 498 F.2d 1303 (2d Cir.), cert. granted, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304). See text at notes 329-73 *infra*.

21. See, e.g., Sherman Act, 15 U.S.C. §§ 1-7 (1970); Clayton Act, 15 U.S.C. §§ 12-27, 44 (1970).

22. 15 U.S.C. §§ 78a-78hh (1970).

23. Originally the NYSE had multiple specialists in single stocks, but the last competing specialist vanished in 1967, and one subsequent application for a competing position was denied. SENATE STUDY, *supra* note 1, at 122. The SEC has recognized that a specialist's capitalization is an important factor in determining his ability to stabilize the market. SPECIAL STUDY, *supra* note 1, pt. 2, at 168, 170.

24. This article makes no attempt to cover such areas as the bond, commodities, or international securities markets. On the bond market, see TREASURY-FEDERAL RESERVE STUDY OF THE GOVERNMENT SECURITIES MARKET, pt. 1 (1959); The Municipal Securities Act of 1973, S. 2474, 93d Cong., 1st Sess. On the commodities market, see The Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389. On the international securities market, see Cohen, *Toward An International Securities Market*, 5 LAW & POLICY IN INTL. BUS. 357 (1973).

I. CURRENT ATTEMPTS TO RECONCILE THE ANTITRUST LAWS WITH THE 1934 ACT

In resolving conflicts between competition and regulation in the stock markets, the courts and Congress have used the antitrust laws and the 1934 Act as proxies for opposing policies.²⁵ Such conflicts have been approached as jurisdictional disputes²⁶ involving two main questions. One is procedural: In what forum are these conflicts to be resolved—the antitrust courts²⁷ or the SEC? The other is substantive: What standard should be employed in each forum—that of the antitrust laws or the 1934 Act? Since these questions have been answered inconsistently with regard to the stock markets,²⁸ as well as other regulated industries,²⁹ a jurisdictional approach may not be the best way to reconcile competitive and regulatory policies.

25. See SENATE STUDY, *supra* note 1, at 233-40; HOUSE STUDY, *supra* note 7, at 160-64.

26. Commentators have usually labeled all facets of this issue as questions of primary jurisdiction. See, e.g., Baxter, *supra* note 16, at 685. But primary jurisdiction comes into play only where a federal agency has concurrent jurisdiction over an action brought in federal court, and the court finds, for reasons of law or policy, that it should defer to the agency in the first instance. 3 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 19.01 (1958). Moreover, the courts have often eschewed the label of primary jurisdiction in dealing with conflicts between antitrust laws and the 1934 Act. See, e.g., Gordon v. NYSE, 498 F.2d 1303, 1309 n.8 (2d Cir.), cert. granted, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304); Thill Sec. Corp. v. NYSE, 433 F.2d 264, 275 (7th Cir. 1970).

27. "Antitrust courts" are synonymous with federal district courts in this context.

28. Compare Note, *Primary Jurisdiction in Antitrust Action Against the New York Stock Exchange: Immunization and Expertise*, 1970 U. ILL. L.F. 544 (primary jurisdiction in agency), with Comment, *An Approach for Reconciling Antitrust Law and Securities Law: The Antitrust Immunity of the Securities Industry Reconsidered*, 65 NW. U. L. REV. 260 (1970) (primary responsibility with courts). For a variety of procedural and substantive approaches, see Baxter, *supra* note 16; Note, *Antitrust and the Securities Industry: Lessons from the Shipping Industry*, 55 CORNELL L. REV. 96 (1969); Note, *Antitrust Laws and the Securities Exchanges*, 66 NW. U. L. REV. 100 (1971); Note, *Antitrust and the Stock Exchange: Minimum Commission or Free Competition?*, 18 STAN. L. REV. 213 (1965); Note, *The New York Stock Exchange Minimum Commission Rate Structure: Antitrust on Wall Street*, 55 VA. L. REV. 661 (1969). For a recognition of the diversity of possible procedural and substantive approaches, see Note, *Fixed Brokerage Commissions: An Antitrust Analysis After the Introduction of Competitive Rates on Trades Exceeding \$500,000*, 85 HARV. L. REV. 794 (1972).

29. Cases involving other regulated industries do not provide a clear-cut guide for the securities industry. The Supreme Court tends to deal with each industry as a unique entity with respect to issues of primary jurisdiction. See *United States v. Philadelphia Natl. Bank*, 374 U.S. 321 (1963) (Comptroller of the Currency); *Pan Am. World Airways v. United States*, 371 U.S. 296 (1963) (CAB); *California v. FPC*, 369 U.S. 402 (1962); *United States v. Radio Corp. of Am.*, 358 U.S. 334 (1959) (FCC); *Federal Maritime Bd. v. Isbrandtsen*, 356 U.S. 481 (1957); *Far East Conference v. United States*, 342 U.S. 570 (1952).

Commentators also have not reached a consensus on the applicability of primary jurisdiction to other regulated industries. Compare Schwartz, *Legal Restriction of Competition in the Regulated Industries: An Abdication of Judicial Responsibility*, 67 HARV. L. REV. 436 (1954) (recommending that the courts retain primary jurisdiction

A. *The Courts*

In the seminal case of *Silver v. NYSE*,³⁰ decided by the Supreme Court in 1963, a nonmember broker sued the NYSE under the Sherman Act after it ordered the discontinuance of his wire connections with the offices of NYSE members without notice, explanation, or a hearing. The Court held that the antitrust court should adjudicate Silver's claim without prior consideration by the SEC, on the ground that the SEC lacked jurisdiction.³¹ Noting that the 1934 Act contains no explicit antitrust exemption for exchanges,³² the Court laid down a substantive test for reconciling antitrust laws with securities regulation: "Repeal [of the antitrust laws] is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."³³ Applying this test to Silver's claim, the Court held that no policy of the 1934 Act was served by severing his wire connections without notice or hearing,³⁴ and therefore the Exchange had acted in violation of the Sherman Act.³⁵

The *Silver* case raises more questions than it answers. In a footnote, the Court explicitly reserved decision on the appropriate forum for reconciling the antitrust laws with the 1934 Act where the dispute is subject to "Commission jurisdiction and ensuing judicial review."³⁶ Moreover, since the Court decided only that the Exchange should give Silver a hearing, the decision says little about the extent of antitrust immunity afforded by the 1934 Act. Lacking guidance from the Supreme Court, lower courts have split on both the procedural and substantive questions in cases involving the stock markets.

over antitrust policies), with Jaffe, *The Effective Limits of the Administrative Process: A Reevaluation*, 67 HARV. L. REV. 1105 (1954), and Jaffe, *Primary Jurisdiction*, 77 HARV. L. REV. 1037 (1964) (both Jaffe articles favor agency primary jurisdiction, the latter more clearly). See also Kenstenbaum, *Primary Jurisdiction To Decide Antitrust Jurisdiction: A Practical Approach to the Allocation of Functions*, 55 GEO. L.J. 812 (1967); von Mehren, *The Antitrust Laws and Regulated Industries: The Doctrine of Primary Jurisdiction*, 67 HARV. L. REV. 929 (1954).

30. 373 U.S. 341 (1963).

31. 373 U.S. at 357-58. According to the Court, the SEC lacked jurisdiction because the dispute involved the application of an exchange rule rather than the validity of the rule itself.

32. 373 U.S. at 357.

33. 373 U.S. at 357.

34. 373 U.S. at 361.

35. 373 U.S. at 365.

36. 373 U.S. at 358 n.12.

1. Choice of Forum

Courts have generally chosen between two forums for resolving conflicts between the antitrust laws and the 1934 Act.³⁷ One alternative is original federal district court jurisdiction over an antitrust suit against an SRO;³⁸ the other is exclusive SEC jurisdiction, subject to judicial review under the "substantial evidence" test.³⁹ In choosing between these forums, the judiciary has focused on the level of supervision exercised by the SEC over the particular SRO action at issue. On the lowest level are SRO actions not subject to SEC oversight: Original jurisdiction lies in the antitrust courts under *Silver*. On the intermediate level are SRO actions subject to SEC approval: Conflicting precedents tend toward initial deference to the SEC, followed by judicial review of the SEC decision. On the final level are SRO actions mandated by the SEC, a problem now before the courts for the first time.

a. *SRO actions not subject to SEC oversight.* While *Silver* upheld original federal court jurisdiction over an antitrust claim that was presumed beyond the scope of SEC oversight,⁴⁰ the Court explicitly

37. The approaches described in the text below are the only two that have been seriously considered by the courts, although other possibilities exist in theory. See Note, 85 HARV. L. REV. 794, *supra* note 32, at 821-25 (suggesting at least five procedures for resolving conflicts).

38. See, e.g., *Thill Sec. Corp. v. NYSE*, 433 F.2d 264 (7th Cir. 1970).

39. See, e.g., *Gordon v. NYSE*, 498 F.2d 1303 (2d Cir.), cert. granted, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304). Securities Exchange Act of 1934, § 25(a), 15 U.S.C. § 78y(a) (1970), provides for the scope of judicial review of SEC actions: "The findings of the Commission as to the facts, if supported by substantial evidence, shall be conclusive." Under the substantial evidence test, the reviewing court must defer to the SEC's factual determinations and interpretation of its broad statutory mandate, and may not substitute its judgment for that of the agency. See 4 K. DAVIS, *supra* note 26, §§ 29, 30.

Judicial review in cases without a formal record of adjudication may be obtained under the Administrative Procedure Act, rather than under the 1934 Act. See text at notes 65-67 *infra*. In such cases, there may be a standard of judicial review other than substantial evidence, such as abuse of discretion. See Administrative Procedure Act § 10(e), 5 U.S.C. § 706 (1970).

40. The Court stated:

Although the Act gives to the Securities and Exchange Commission the power to request exchanges to make changes in their rules . . . , and impliedly, therefore, to disapprove any rules adopted by an exchange . . . , it does not give the Commission jurisdiction to review particular instances of enforcement of exchange rules This aspect of the statute, for one thing, obviates any need to consider whether petitioners were required to resort to the Commission for relief before coming into court.

373 U.S. at 357-58.

The rule-application distinction relied upon by the Court to deny SEC jurisdiction has been attacked by Professor Baxter as a "sophistical" device inadequate to resolve the difficult question of when the jurisdiction of the SEC should be invoked. Professor Baxter notes that the issue of a hearing requirement in *Silver* could have been con-

reserved decision on the appropriate forum for resolving claims against SRO actions subject to (1) "Commission jurisdiction" and (2) "ensuing judicial review."⁴¹ Since almost all SRO actions can be construed under the developing case law as subject to "Commission jurisdiction," and almost all SEC decisions are subject to "ensuing judicial review," *Silver* will rapidly become irrelevant as a procedural precedent.

The scope of the phrase "Commission jurisdiction" was explored by analogy in *Ricci v. Chicago Mercantile Exchange*,⁴² the most important Supreme Court opinion after *Silver* to deal with the conflict between the antitrust laws and the regulation of exchanges.⁴³ Although the jurisdiction of the Commission over the complaint was dubious,⁴⁴ and exercisable at the sole discretion of the Commission,⁴⁵ the majority in *Ricci* took the position that "there is sufficient

sidered a proper subject for the exercise of the SEC's section 19(b) power "to alter or supplement" exchange rules. He concludes:

I do mean to suggest that a serious problem of primary jurisdiction was raised by *Silver*, that the Supreme Court was not persuaded that the SEC should first have determined the propriety of the NYSE procedures, and that the court evaded the primary jurisdiction question by means of a sophistical distinction. Since the issue did not receive serious consideration in *Silver*, it would be foolhardy to assume that the Court will necessarily adhere to the rule-versus-adjudication distinction if the fixed commission question comes before the Supreme Court in an antitrust context. Baxter, *supra* note 16, at 687-88.

41. Were there Commission jurisdiction and ensuing judicial review for scrutiny of a particular exchange ruling, as there is . . . to examine disciplinary action by a registered securities association (*i.e.*, by the NASD) . . . , a different case would arise concerning exemption from the operation of laws designed to prevent anti-competitive activity, an issue we do not decide today. 373 U.S. at 358 n.12.

42. 409 U.S. 289 (1973). The Chicago Mercantile Exchange (CME) is a commodities market somewhat similar in structure and function to the NYSE. Like the NYSE, the CME and its members are subject to governmental regulation. The CME is subject to the supervision of the Commodity Exchange Commission pursuant to the Commodity Exchange Act of 1936, 7 U.S.C. §§ 1-17b (1970). The Commodity Exchange Commission, created only two years after the SEC, parallels the SEC in some respects, but its regulatory power was formerly much narrower. On October 23, 1974, new legislation broadening the powers of the Commodity Exchange Commission was enacted. *See Commodity Futures Trading Commission Act of 1974*, Pub. L. No. 93-463, 88 Stat. 1389; *President Ford Signs Commodity Futures Trading Commission Bill*, BNA SEC. REG. & L. REP. No. 275, at A-3 (Oct. 30, 1974).

The plaintiff in *Ricci* alleged that the transfer of his membership was a violation of CME rules, and, therefore, a violation of the Commodity Exchange Act and an "unlawful conspiracy aimed at restraining" competition in violation of the antitrust laws. 409 U.S. at 290-91.

43. The Supreme Court also decided *Chicago Mercantile Exch. v. Deaktor*, 414 U.S. 113 (1973), which closely follows *Ricci*, and *Merrill Lynch, Pierce, Fenner & Smith v. Ware*, 414 U.S. 117 (1973), involving the relationship of the 1934 Act to certain state laws on employment agreements and restraint of trade.

44. 409 U.S. at 309-21 (Marshall, J., joined by Douglas, Stewart & Powell, JJ., dissenting).

45. Justice Marshall noted that the Commodity Exchange Commission (CEC) "may" order the Exchange to enforce its own rules pursuant to the Commodity Exchange

statutory support for administrative authority in this area that the agency should at least be requested to institute proceedings."⁴⁶ If "Commission jurisdiction" is thus equated with an arguable potential for SEC oversight,⁴⁷ it encompasses almost all antitrust claims against SRO's. For instance, as to the content of SRO rules, the SEC can disapprove any new rule of the NASD,⁴⁸ abrogate existing NASD rules in four procedural areas,⁴⁹ and effectively change NASD rules by imposing new "interpretations."⁵⁰ The SEC can alter or supplement exchange rules in twelve areas and with respect to "similar matters," which arguably cover most aspects of SRO activity.⁵¹ It

Act (Act), but the Act does not require the CEC to issue such an order at the instance of the plaintiff. Indeed, the Act expressly permits the CEC to ignore "minor violations." 409 U.S. at 310-11 (dissenting opinion).

46. 409 U.S. at 304.

47. The concept of potential oversight as a ground for deferring to the agency is consonant with some recent lower court decisions. In *Ohio AFL-CIO v. Insurance Rating Bd.*, 451 F.2d 1178 (6th Cir. 1971), *cert. denied*, 409 U.S. 917 (1972), the court held that insurance rates are immune from antitrust attack if the state generally regulates the insurance business, even though specific rates could go into effect without state approval and the state's regulatory scheme is not enforced. In *Washington Gas Light Co. v. Virginia Elec. & Power Co.*, 438 F.2d 248 (4th Cir. 1971), the court held that state regulation of electric power rates cloaks the activities of electric power companies with antitrust immunity, even though there has been "administrative silence" with respect to the challenged scheme. For a critique of the *Washington Gas Light* case, see 85 HARV. L. REV. 670, 670-74 (1972).

48. Securities Exchange Act of 1934, § 15A(j), 15 U.S.C. § 78o-3(j) (1970), empowers the SEC to disapprove "[a]ny change in or addition to" NASD rules within 30 days after the new rule is proposed. See note 13 *supra*.

49. Securities Exchange Act of 1934, § 15A(k), 15 U.S.C. § 78o-3(k) (1970), authorizes the SEC to change or abrogate NASD rules in specified areas. See note 12 *supra*. For a recent application of this authority, see SEC Securities Exchange Act Release No. 9632 (June 7, 1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,831.

50. The imposition of new interpretations of NASD rules arises out of the SEC's power to review any disciplinary action taken by the NASD or any denial of membership in the NASD. See Securities Exchange Act of 1934, §§ 15A(g), (h), 15 U.S.C. §§ 78o-3(g), (h) (1970). In SEC Securities Exchange Act Release No. 9632, *supra* note 49, the SEC, in reviewing a NASD disciplinary action, held that the Association "improperly construed and applied" its own rule, and ordered the NASD to promulgate an interpretation of the rule consistent with the SEC's view. *Id.* at 81,825. The SEC reviewed a similar disciplinary proceeding in SEC Securities Exchange Act Release No. 10643 (Feb. 14, 1974), and held that the NASD had "no authority" after the earlier disciplinary review to enforce its rules in disregard of the SEC interpretation. By so holding, the SEC affirmed its belief that disciplinary proceedings have a prospective effect on the enforcement of NASD rules.

51. Securities Exchange Act of 1934, § 19(b), 15 U.S.C. § 78s(b) (1970), empowers the SEC to alter or supplement exchange rules. See note 12 *supra*. The SEC is reluctant to use its section 19(b) powers formally and has done so only four times; in only two of those instances has the Commission gone through a full section 19(b) proceeding. For a discussion of the first two instances, see Note, *Informal Bargaining Process: An Analysis of the SEC's Regulation of the New York Stock Exchange*, 80 YALE L.J. 811, 822-25 (1971). Within the last two years the SEC has adopted rule 19b-2, SEC Securities Exchange Act Release No. 9950 (Jan. 16, 1973), CCH FED. SEC. L. REP. SPECIAL REPORT No. 460 (dealing with institutional membership on exchanges), and pro-

may replace SRO rules with its own rules in designated areas,⁵² and has the power to deregister SRO's if their rules do not meet certain criteria.⁵³ As to the administration of SRO rules, the SEC can review NASD disciplinary proceedings,⁵⁴ and a combination of judicial precedent and statute arguably gives the SEC the power to attack nonenforcement of SRO rules.⁵⁵ The only significant gaps in the

posed rule 19b-3, SEC Securities Exchange Act Release No. 11073, *supra* note 16. These infrequent invocations of the SEC's regulatory power should not be interpreted as a sign that the SEC's oversight jurisdiction is limited. For the Commission's view of the expansive scope of its section 19(b) powers, see SEC Securities Exchange Act Release No. 9950, *supra*, at 54-70.

52. Under Securities Exchange Act of 1934, § 11, 15 U.S.C. § 78k (1970), the SEC has direct authority to prescribe rules for exchange specialists, odd-lot dealers, and floor traders. This direct rule-making authority supercedes exchange self-regulation. However, only twice has the SEC promulgated rules under section 11. See Note, *supra* note 51, at 815 n.32, 819-21. Under Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j (1970), the SEC has direct authority over short sales, stop-loss orders, and manipulative devices in all stock markets. The SEC has utilized section 10 in a variety of situations that affect SRO activities. See rules 10a-1, -2, 17 C.F.R. §§ 240.10a-1, -2 (1974) (regulating short sales); rules 10b-1 to -16, 17 C.F.R. §§ 240.10b-1 to -16 (1974) (covering a broad range of SRO members' activities). Cf. Jennings, *supra* note 7, at 682-84.

53. Securities Exchange Act of 1934, § 19(a)(1), 15 U.S.C. § 78s-(a)(1) (1970), provides for exchange suspension; § 15A(b), 15 U.S.C. § 78o-3(b) (1970), authorizes the SEC to suspend the NASD. The SEC has utilized this power only once, however. See SEC Securities Exchange Act Release No. 7870 (April 22, 1966), [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,343; *San Francisco Mining Exch. v. SEC*, 378 F.2d 162 (9th Cir. 1967). After the 1964 passage of provisions providing for NASD suspension, Professor Loss commented: "This new suspension authority thus reinforces the Commission's previous authority over association rules to perhaps a greater extent than first meets the eye, in that it may well empower the Commission to push through any new rule governing the substantive conduct of members, without limitation to the four categories of rules in § 15A(k)(2) . . ." 5 L. LOSS, *SECURITIES REGULATION* 3450 (2d ed. rev. 1969) (emphasis original). For a discussion of SEC suspension powers over exchanges, see 2 *id.* at 1171-78 (2d ed. 1961).

54. Securities Exchange Act of 1934, §§ 15A(g), (h), 15 U.S.C. §§ 78o-3(g), (h) (1970). The SEC has no comparable review powers over exchange disciplinary proceedings.

55. See 2 L. LOSS, *supra* note 53, at 1172-78; Dawidoff, *The Power of the Securities and Exchange Commission To Require Stock Exchanges To Discipline Members*, 41 *FORDHAM L. REV.* 549, 559-68 (1973); Note, *Exchange Liability for Net Capital Enforcement*, 73 *COLUM. L. REV.* 1262 (1973).

Securities Exchange Act of 1934, § 6, 15 U.S.C. § 78f (1970), requires exchanges to provide for the enforcement of their own rules in order to be registered with the SEC. In a series of cases, the courts have held that this requirement imposes upon the exchanges a duty to enforce their own rules and creates a private cause of action against the exchanges for failing to do so, subject to several possible defenses. See *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); *Kroese v. NYSE*, 227 F. Supp. 519 (S.D.N.Y. 1963).

Securities Exchange Act of 1934, § 20, 15 U.S.C. § 78t (1970), imposes liability upon controlling persons for violations of the securities laws by their controlled persons. See Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 *N.Y.U. L. REV.* 1019 (1973). In one recent case, a court stated that the duties of a controlling person under section 20 impose a duty on the exchanges to enforce their rules, although no exchange liability was found in that case. *Hughes v. Dempsey-Tegeler & Co.*, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,133 (C.D. Cal. 1973).

SEC's power over SRO's are in the review of new rules⁵⁶ and disciplinary hearings by exchanges,⁵⁷ and in the alteration of existing NASD rules in substantive areas.⁵⁸

Under *Ricci*, therefore, antitrust courts will refuse to hear most claims involving SRO's prior to the conclusion of proceedings before the Commission.⁵⁹ If the Commission takes action on a claim, there will generally be judicial review of its decision—the second branch of the *Silver* exception.⁶⁰ The traditional route for judicial review of SEC decisions is section 25 of the 1934 Act, which permits the federal courts of appeals to hear cases involving “an order issued by the Commission.”⁶¹ This section clearly applies to formal adjudications by the SEC, such as Commission orders reversing disciplinary actions by the NASD.⁶² While the courts have recently taken a narrow view of what constitutes a Commission order under section 25,⁶³ other types of SEC decisions⁶⁴ will be increasingly subject to judicial

When either of these provisions is violated or about to be violated, the SEC can investigate (with the power of subpoena), Securities Exchange Act of 1934, §§ 21(a), (b), 15 U.S.C. §§ 78u(a), (b) (1970), bring an action for injunctive relief in federal district court, Securities Exchange Act of 1934, § 21(e), 15 U.S.C. § 78u(e) (1970), and suspend or expel SRO members and officers. Securities Exchange Act of 1934, § 19(a)(3), 15 U.S.C. § 78s-(a)(3) (1970).

56. Exchanges need only submit their rule changes to the SEC after they are adopted. See note 13 *supra*. Since the SEC can alter or supplement exchange rules, however, it may obtain jurisdiction over new rules once they are in force. See note 12 *supra* and accompanying text.

57. See note 14 *supra*.

58. The SEC has the power to alter or supplement NASD rules in four procedural areas. See note 12 *supra*. However, the SEC can also change NASD rules to promote fair standards of internal governance, see note 12 *supra*, and can change NASD rules by “interpretations.” See note 50 *supra* and accompanying text.

59. See *Chicago Mercantile Exch. v. Deaktor*, 414 U.S. 113 (1973) (per curiam), in which the Court reversed a district court's refusal to stay its proceedings on antitrust and Commodities Exchange Act claims until the Commodities Exchange Commission was given an opportunity to take some action.

60. See text at note 41 *supra*.

61. 15 U.S.C. § 78y (1970).

62. Securities Exchange Act of 1934, § 15A(h), 15 U.S.C. § 78o-3(h) (1970), empowers the SEC to reverse NASD disciplinary proceedings by order.

63. Compare *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), vacated as moot, 404 U.S. 403 (1972), with *Kixmiller v. SEC*, 492 F.2d 641 (D.C. Cir. 1974).

In *Medical Committee* the court held that Commission acquiescence in an SEC staff no-action letter permitting a corporation to exclude the petitioner's proposals from management's proxy materials was a reviewable order under section 25 of the 1934 Act, 15 U.S.C. § 78y (1970). However, the court retreated from this broad interpretation in *Kixmiller*, in which it held that the Commission's failure to act was not reviewable under section 25. The court in *Kixmiller* distinguished *Medical Committee* on the ground that *Kixmiller* involved the Commission's “affirmance of the staff's” no-action letter. 492 F.2d at 644.

64. A problem permeating SEC control of SRO action is that frequently control is

review under the Administrative Procedure Act (APA).⁶⁵ For instance, the District of Columbia Court of Appeals has held that a district court had jurisdiction under the APA to review a Commission request for a change of an exchange rule.⁶⁶ Similarly, the SEC has acquiesced in district court review under the APA of the Commission's institutional membership rule.⁶⁷

Thus, *Silver* is relevant procedural precedent only when the Commission does not have jurisdiction over the dispute⁶⁸ or chooses not to invoke its jurisdiction.⁶⁹ In either case, the antitrust court should assume jurisdiction over the dispute under *Silver*, as the Supreme Court made clear in a footnote to *Ricci*.⁷⁰

exercised through nonreviewable informal SEC negotiations with SRO's, instead of by formal orders. See Note, *supra* note 51. Even when the SEC approves an SRO rule, it usually issues a letter of "non-objection," rather than a formal order reviewable under section 25. See SENATE STUDY, *supra* note 1, at 199-201.

65. Administrative Procedure Act § 10(c), 5 U.S.C. § 704 (1970), provides that "final agency action for which there is no other adequate remedy in a court [is] subject to judicial review."

66. Independent Broker-Dealers Trade Assn. v. SEC, 442 F.2d 132 (D.C. Cir. 1971). Reversing a dismissal by the district court for lack of jurisdiction, the court of appeals held that section 10(c) of the APA gave the district court jurisdiction to review informal but final agency determinations. The court also held that section 25 of the 1934 Act, providing for court of appeals jurisdiction and review of Commission "orders," did not preclude district court jurisdiction and review of the broader category of final agency action. 442 F.2d at 136-43.

67. In PBW Stock Exch., Inc. v. SEC, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974), the court of appeals held that it had no jurisdiction under the APA or section 25 to review an SEC rule not promulgated as an order. In its brief for denial of certiorari, the SEC admitted that the petitioners could presumably obtain pre-enforcement review of the SEC's action in the district court under the APA. Brief for the SEC in Opposition to Petition for a Writ of Certiorari, in BNA SEC. REG. & L. REP. No. 249, at F-3 (April 24, 1974). Subsequently, the PBW Exchange filed papers in the district court for review of the SEC rule. PBW Stock Exch., Inc. v. SEC, BNA SEC. REG. & L. REP. No. 252, at E-1 (E.D. Pa. May 15, 1974). Jurisdiction in the new suit was asserted in partial reliance upon section 10(c) of the APA.

68. See text at notes 56-58 *supra*.

69. See *Jacobi v. Bache & Co.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 (S.D.N.Y. 1974). *Jacobi* was a class action by two former registered representatives of exchange brokerage firms, alleging a conspiracy by exchange members and the NYSE to limit the representatives' commissions. For a period of more than a year—between 1970 and 1971—the exchange required an add-on service charge for brokerage commissions on exchange transactions but excluded this add-on charge from the calculation of representative commissions (which were otherwise calculated on the basis of brokerage commission charges). The SEC approved the NYSE add-on charge but disclaimed "any responsibility to intervene in firms' policies concerning compensation to registered representatives, unless a showing were made that such intervention was necessary for the protection of investors." [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 at 96,021.

70. "[S]urely if administrative proceedings are sought in vain, there would be no further problem for the antitrust court." *Ricci v. Chicago Mercantile Exch.*, 409 U.S. 289, 304-05 n.14 (1973). Similarly, the district court in *Jacobi v. Bache & Co.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 (S.D.N.Y. 1974), assumed jurisdiction over antitrust claims because the SEC had already disclaimed any responsibility to intervene.

b. *SRO actions subject to SEC oversight.* Since most antitrust claims will involve SRO actions subject to SEC jurisdiction and ensuing judicial review, the lower courts will find little procedural guidance from the Supreme Court's opinion in *Silver*. They will also find limited assistance in *Ricci* if the SEC does hear the dispute. As Chief Justice Burger emphasized in *Ricci*: "The Court's opinion should not be read to suggest that the Commission's resolution of the dispute either will or will not foreclose subsequent application of the antitrust law."⁷¹ The most troublesome cases are those in which the SEC explicitly or tacitly approves the SRO action.

The issue of the appropriate forum for resolving antitrust claims in this category was first litigated in *Kaplan v. Lehman Brothers*,⁷² in which shareholders of certain mutual funds challenged the NYSE's fixed commissions. The district court granted summary judgment for the NYSE because the plaintiffs erroneously alleged a per se violation of the antitrust laws.⁷³ It distinguished *Silver* on the ground that agency review was available in *Kaplan*, because "the SEC exercises a general and continuing power to change, alter, or supplement the rules of the Exchange fixing the rates of commission."⁷⁴ In affirming, the Seventh Circuit noted the SEC's jurisdiction over commission rates and summarily concluded that antitrust recovery in such a case was outside the intent of Congress.⁷⁵

In *Thill Securities Corp. v. NYSE*,⁷⁶ however, a different panel of the Seventh Circuit held that original jurisdiction in the antitrust court might be appropriate despite SEC jurisdiction over the anti-rebate rule at issue.⁷⁷ The court attempted to distinguish *Kaplan* on

71. 409 U.S. at 308 (concurring in a 5-4 decision).

72. 250 F. Supp. 562 (N.D. Ill. 1966), *affd.*, 371 F.2d 409 (7th Cir.), *cert. denied*, 389 U.S. 954 (1967).

73. 250 F. Supp. at 564-65.

74. 250 F. Supp. at 566.

75. 371 F.2d at 411.

76. 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971).

77. The court in *Thill* remanded the case to the district court for a determination whether invocation of SEC jurisdiction was appropriate. In a concurring opinion, Judge Swygert made clear that the court was not deciding whether the SEC should be allowed to make the first decision in the case. 433 F.2d at 276. On remand, the district court denied a motion to apply the doctrine of primary jurisdiction and refer the case to the SEC. *See Thill Sec. Corp. v. NYSE*, 469 F.2d 14 (7th Cir. 1972) (district court's order not appealable).

Thill was followed by a district court in the Seventh Circuit. *See Frederickson v. Merrill Lynch, Pierce, Fenner & Smith*, BNA SEC. REG. & L. REP. No. 271, at D-1 (Oct. 2, 1972). The plaintiff in *Frederickson* alleged that the fixed commissions used on various stock exchanges violated the antitrust laws. Although the SEC has jurisdiction over fixed rates under section 19(b) of the 1934 Act, the court denied the defendant's motion to defer to the SEC, on the ground that the agency had sanctioned the alleged violations. Since the 1934 Act did not provide for an express exemption from the antitrust laws, SEC approval did not oust the antitrust court's jurisdiction.

the grounds that the plaintiffs in *Thill* did not allege a per se violation of the antitrust laws, that the anti-rebate rule, unlike the fixed commission rule, could be used to injure particular competitors, and that there was no evidence that the SEC was currently exercising its jurisdiction over anti-rebate rules.⁷⁸ However, the *Thill* court stated that even if the SEC had been exercising its supervisory power, the exchange would not necessarily have antitrust immunity, because the SEC is not required to consider the anticompetitive effects of exchange rules and has been historically reluctant to do so.⁷⁹

While *Thill* does not expressly overrule *Kaplan*, the two cases are clearly inconsistent.⁸⁰ In *Gordon v. NYSE*,⁸¹ an antitrust attack on fixed commission rates, the Second Circuit followed *Kaplan* and rejected *Thill* to the extent that it was inconsistent.⁸² The Supreme Court has recently granted certiorari in *Gordon* in light of the split in the lower courts.⁸³

The remaining issue was an implied exemption under the antitrust laws, a question upon which SEC expertise was helpful but not determinative.

78. 433 F.2d at 270-71.

79. 433 F.2d at 271-73.

80. The three grounds given by the *Thill* court for distinguishing *Kaplan* are tenuous. Under modern procedure, the type of plea should not be dispositive of a case. See, e.g., *United States v. Morgan*, 118 F. Supp. 621 (S.D.N.Y. 1953) (action brought under a per se theory but court proceeded under the rule of reason). Fixed commissions were especially injurious to institutional investors (the plaintiffs in *Kaplan*), and were indeed the main reason behind the anti-rebate rule. See Note, 66 Nw. U. L. Rev. 100, *supra* note 28, at 106 n.40. Finally, the SEC was as involved with the anti-rebate rule at the time of *Thill* as it had been with fixed commission rates at the time of *Kaplan*. See SEC Securities Exchange Act Release No. 8324 (May 28, 1968), [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,557.

81. 498 F.2d 1303 (2d Cir.), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

82. See also *Robert W. Stark, Jr., Inc. v. NYSE*, 346 F. Supp. 217 (S.D.N.Y. 1972), which follows *Kaplan* on the ground that the SEC had jurisdiction over exchange membership rules, the subject of the dispute.

83. A similar split exists in cases dealing with antitrust attacks on NASD rules. Section 15A of the 1934 Act, 15 U.S.C. § 78o-3 (1970), governs NASD rules and explicitly requires that the NASD constitution be designed "to remove impediments to and perfect the mechanism of a free and open market." Securities Exchange Act of 1934, § 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (1970). It also provides that, "if any provision of this section is in conflict with any provision of any law of the United States," the section 15A provisions shall prevail. Securities Exchange Act of 1934, § 15A(n), 15 U.S.C. § 78o-3(n) (1970).

The court in *Harwell v. Growth Programs, Inc.*, 451 F.2d 240 (5th Cir. 1971), *rehearing denied*, 459 F.2d 461, *cert. denied*, 409 U.S. 876 (1972), decided that the repealer in section 15A was (with one exception) the equivalent to the *Silver* "necessity" test, which should therefore be applied to NASD actions. On denial of rehearing the *Harwell* court made clear that if the *Silver* "necessity" test could not be met, "then the mere supervisory presence of the SEC cannot divest the courts of their power to enforce the antitrust laws." 459 F.2d at 462. More recently, in *Haddad v. Crosby Corp.*, 374 F. Supp. 95 (D.D.C. 1973), *prob. juris. noted sub nom. United States v. NASD*, 43 U.S.L.W. 3207 (U.S. Oct. 9, 1974) (No. 73-1701), the court came to the opposite con-

Neither *Kaplan* nor *Thill* provides a satisfactory procedure for weighing the competitive and regulatory factors affecting stock markets.⁸⁴ Original jurisdiction over SRO actions in an antitrust court is an excellent method of constraining anticompetitive behavior.⁸⁵ The antitrust courts are very experienced in dealing with problems of competition,⁸⁶ and can hand out stiff penalties⁸⁷ that may deter unreasonable restraints on trade. They can check pressure on the SEC from the securities industry,⁸⁸ and impede the SEC's bureaucratic interest in expanding its regulatory role.⁸⁹ But the antitrust courts have little expertise in dealing with the particular problems of the securities industry. Also, treble damages in private antitrust suits may seem too harsh⁹⁰ for an SRO acting under explicit or im-

clusion about antitrust immunity, although *Haddad* and *Harwell* both concerned open-ended investment companies regulated under both the 1940 Investment Company Act and the 1934 Act. The *Haddad* court gave implied antitrust immunity to the fund on the ground that the competitive standard and antitrust exemption in section 15A made the *Silver* "necessity" test irrelevant to NASD actions. 374 F.2d at 111-12.

84. As Professor Baxter has observed, the choice of forum gives one side or the other the "home-court advantage." Baxter, *supra* note 16, at 683.

85. Professor Schwartz proposes that "judges rather than commissioners should shape the large outlines of our national economic policy, where Congress has not stated its will." Schwartz, *supra* note 29, at 473. He observes that agencies tend to ignore the benefits of competition, and courts tend in reviewing agency decisions to equate the power to regulate with the power to sanction restraints on competition. He argues that an agency's technical expertise in its field is not necessarily a reason for allowing the agency to determine the extent of competition in that field. Professor Schwartz concludes that, absent explicit congressional policy to the contrary, antitrust courts should decide antitrust issues, because they are more likely than agencies to provide an independent check on regulations that curtail competition. Schwartz, *supra*, at 471-73. But see Jaffe, 67 HARV. L. REV. 1105, *supra* note 29; Jaffe, 77 HARV. L. REV. 1037, *supra* note 29. In his 1954 article Professor Jaffe made the same critical observations of agency "expertise" as Professor Schwartz, but disagreed with Professor Schwartz's conclusions. Jaffe, 67 HARV. L. REV. 1105, *supra*, at 1134-35. In his 1964 article, however, Professor Jaffe declared that it was "dogmatic" to presume "that effective antitrust regulation must be exclusively judicial." Jaffe, 77 HARV. L. REV. 1037, *supra*, at 1070.

86. "[I]t should be remembered that the courts of the United States have over the years become the repository of antitrust expertise." *Thill Sec. Corp. v. NYSE*, 443 F.2d 264, 273 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971). See Note, 85 HARV. L. REV. 794, *supra* note 28, at 808.

87. The antitrust laws provide for civil damages of triple the loss sustained by the plaintiff (treble damages) plus reasonable attorney fees. Clayton Act § 4, 15 U.S.C. § 15 (1970).

88. For an analysis of the way in which the NYSE influences SEC regulatory programs, see Note, *supra* note 51.

89. See generally M. CROZIER, *THE BUREAUCRATIC PHENOMENON* (1964); R. LANE, *THE REGULATION OF BUSINESSMEN* (1954); Jordan, *Producer Protection, Prior Market Structure, and the Effects of Government Regulation*, 15 J. LAW & ECON. 151-76 (1972).

90. For example, in *Thill* the claim was for \$21 million in treble damages. *Thill Sec. Corp. v. NYSE*, 433 F.2d 264, 267 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971). A claim for actual damages of \$1 billion has since been filed. *Reinisch v. NYSE*, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,820 (S.D.N.Y. 1970).

plicit approval of the SEC.⁹¹ Finally, the courts have an institutional stake in limiting encroachments on the judicial function; they may refuse to recognize implied exceptions to the antitrust laws claimed by regulatory agencies.⁹²

Conversely, SEC determination followed by judicial review under the substantial evidence rule⁹³ is sensitive to regulatory considerations but not to competitive factors. The reviewing court can rely on the SEC's expertise concerning the stock markets, and require the SEC to present empirical data supporting its position on regulatory issues.⁹⁴ If the SEC has abused its discretion, the court will grant injunctive relief rather than impose treble damages. In formulating regulatory policy, however, the SEC has little antitrust expertise⁹⁵ and has traditionally been unreceptive to competitive concerns.⁹⁶ While courts may require the Commission to consider competitive

Professor Baxter observes: "In both *Kaplan* and *Thill Securities* private plaintiffs were seeking treble damages in addition to a declaration of invalidity, and judicial reluctance to impose treble damages was probably responsible, at least in part, for the analytical inadequacies of the opinions rendered in those cases." Baxter, *supra* note 16, at 692 (footnote omitted).

91. Clayton Act § 4, 15 U.S.C. § 15 (1970), states: "Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . . and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee" (emphasis added).

Some commentators have maintained without citation to legal authority that a district court may find an antitrust violation by an SRO and not award treble damages. Baxter, *supra* note 16, at 692; Note, 85 HARV. L. REV. 794, *supra* note 28, at 822. In an early case, the Supreme Court refused to award money damages against a common carrier for rates approved by the ICC. *Keogh v. Chicago & Nw. Ry. Co.*, 260 U.S. 156 (1922) (*semble*). Recently, the Court in dicta has hinted at some principles that would allow courts to grant only prospective relief in antitrust suits. *See Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481, 499 (1968). In fact the Court has supported the award of treble damages when the defendant relied on prior precedent in good faith, *Simpson v. Union Oil Co.*, 396 U.S. 13 (1969) (*per curiam*); when the plaintiff was in *pari delicto* with the defendant, *Perma Life Mufflers, Inc. v. International Parts Corp.*, 392 U.S. 134, 139 (1968); and when a regulated industry went beyond the limits of an express antitrust exemption. *Carnation Co. v. Pacific West-bound Conference*, 383 U.S. 213 (1966). *See generally* P. AREEDA, ANTITRUST ANALYSIS 68-69 (2d ed. 1974).

92. In cases involving several different regulated industries, the Supreme Court has repeated the reasoning first set out in *United States v. Borden Co.*, 308 U.S. 188, 198-99 (1939), and affirmed most concisely in *United States v. Philadelphia Natl. Bank*, 374 U.S. 321, 350-51 (1963), that "[r]epeals of the antitrust laws by implication are disfavored, and have only been found in cases of plain repugnancy between the antitrust and regulatory provisions." *See also* *Federal Maritime Commn. v. Seatrain Lines, Inc.*, 411 U.S. 726, 733 (1972), and cases cited therein; *Silver v. NYSE*, 373 U.S. 341, 357 (1963).

93. *See* note 39 *supra* and accompanying text.

94. *Cf.* *SEC v. Chenery Corp.*, 318 U.S. 80, 87-94 (1943).

95. Note, 85 HARV. L. REV. 794, *supra* note 28, at 822.

96. *See, e.g.,* SENATE STUDY, *supra* note 1, at 238; Comment, *supra* note 28, at 295.

issues,⁹⁷ courts do not have much leverage if the SEC—as the sole fact-finder—develops a record showing such consideration.⁹⁸ Also, since courts cannot grant money damages in reviewing administrative decisions,⁹⁹ private parties have limited financial incentive to challenge SEC decisions, especially those involving only past anticompetitive activity.¹⁰⁰

c. *SRO actions directed by the SEC.* While the Justice Department has resisted deference to agency proceedings in cases involving SRO actions merely approved by the SEC,¹⁰¹ it has agreed with the SEC's position that antitrust courts do not have jurisdiction over SRO actions directed by the Commission.¹⁰² The SEC's legal position is

97. See *Municipal Elec. Assn. v. SEC*, 413 F.2d 1052 (D.C. Cir. 1969) (anticompetitive considerations are among the public interest factors that the SEC must consider in approving a merger under the Public Utilities Holding Company Act). In an analogous situation, the Supreme Court has recently held that the Federal Power Commission was required to consider "antitrust and anticompetitive issues" because this "serves the important function of establishing a first line of defense against those competitive practices that might later be the subject of antitrust proceedings." *Gulf States Util. Co. v. FPC*, 411 U.S. 747, 760 (1973).

98. Even if the SEC must take account of antitrust policies, the 1934 Act does not stipulate what weight it should give them. The SEC has taken the position that a judicial mandate to consider competition "hardly suggests . . . that the antitrust laws will have determinative significance . . ." Brief for the SEC at 86, *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974) [hereinafter SEC Brief].

Where an agency has failed to assess some factor under a broad public interest standard, the courts will often require nothing more than mere consideration of the factor. See, e.g., *Hanly v. Kleindienst*, 471 F.2d 823, 833-36 (2d Cir. 1972), *cert. denied*, 412 U.S. 908 (1973) (dictum); *Hanly v. Mitchell*, 460 F.2d 640 (2d Cir.), *cert. denied*, 409 U.S. 990 (1972).

99. Jurisdiction for administrative review of SEC action may be obtained under section 704 of the APA or section 25 of the 1934 Act. See text at notes 61-67 *supra*. Neither of these statutory provisions permits the granting of money damages. The doctrine of sovereign immunity will normally prevent damage suits against the government absent specific statutory authorization. See generally 3 K. DAVIS, *supra* note 26, § 25.01.

100. An injured party is far more likely to pursue an antitrust remedy (with the possibility of treble damages and attorney fees) than to appeal an administrative decision. Recently, however, attorney fees have been awarded in a few suits seeking review of administrative decisions. See, e.g., *National Resources Defense Council, Inc. v. EPA*, 484 F.2d 1331 (1st Cir. 1973).

101. See BNA SEC. REG. & L. REP. No. 256, at A-3 (June 12, 1974).

102. See, e.g., Letter from Thomas E. Kauper, Assistant Attorney General, Antitrust Division, United States Department of Justice, to Hon. Harrison A. Williams, Jr., Chairman of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, Feb. 11, 1974, at 3:

Under existing law, conduct of self-regulatory organizations or their members which is mandated by the Securities and Exchange Commission would be exempt from the antitrust laws. The antitrust laws have long recognized a distinction between voluntary business conduct and conduct mandated by affirmative action of a governmental body. The latter is not private volitional action which would subject a self-regulatory organization or its members to antitrust liability.

The SEC's position was articulated in its brief in the *PBW* case:

[I]t should be clear that when the Commission itself takes action or directs a

grounded in *Parker v. Brown*,¹⁰³ which gave antitrust immunity to state officials acting within the scope of their authority.¹⁰⁴ If a governmental agency directs a private body to take certain action, the SEC argues, then the antitrust immunity of state officials extends to the private party.¹⁰⁵ On policy grounds, private parties should not be forced to choose between violating the antitrust laws and violating a governmental mandate. If the private party chooses to obey the governmental mandate, it would be particularly unjust to impose the antitrust penalty of treble damages.

The SEC's argument, however, is subject to dispute on legal and policy grounds. *Parker* is a questionable precedent for SEC cases because the Court in *Parker*, faced with a conflict between state regulations and federal antitrust laws, gave considerable weight to the desirability of retaining a state role in the economic field.¹⁰⁶ In the SEC cases, of course, federalism is irrelevant. Moreover, to the extent that *Parker* is a valid precedent for SEC cases, it applies to only a narrow range of SEC directives.¹⁰⁷ The cases spawned by *Parker* tend to show that antitrust immunity attaches only when the governmental directive itself is the source of anticompetitive activity, and where the government actually formulates the directive.¹⁰⁸ The SEC has often issued rules that effectively direct SRO's to formulate

self-regulatory authority to take action based upon a finding by the Commission that its action is within the scope and purposes of the Securities Exchange Act, there can be no direct application of the antitrust laws.
SEC Brief, *supra* note 98, at 87 (emphasis original).

103. 317 U.S. 341 (1943).

104. 317 U.S. at 350-51.

105. The SEC relies on *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 136 (1961): "Where a restraint upon trade or monopolization is the result of valid governmental action, as opposed to private action, no violation of the [Sherman] Act can be made out." SEC Brief, *supra* note 98, at 86 n.219.

106. See Handler, *Twenty-Fourth Annual Antitrust Review*, 72 COLUM. L. REV. 1, 7 (1972). Professor Handler argues that if *Parker* had gone the other way, all state regulation affecting interstate commerce would be subject to antitrust attack. Therefore, the Court in *Parker* simply recognized the important role state governments have in regulating business. For a more moderate viewpoint, see Slater, *Antitrust and Governmental Action: A Formula for Narrowing Parker v. Brown*, 69 NW. U. L. REV. 71 (1974).

107. See Posner, *Parker v. Brown Revisited*, 50 N.Y.U. L. REV. 693 (1975). Professor Posner argues that the exemption granted in *Parker* should be narrowed even further than it has been.

108. See, e.g., *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384, 389 (1951) (*semble*); *Norman's on the Waterfront, Inc. v. Wheatley*, 444 F.2d 1011, 1016-18 (3d Cir. 1971); *Asheville Tobacco Bd. of Trade, Inc. v. FTC*, 263 F.2d 502, 508-10 (4th Cir. 1959). See also ABA, SUPPLEMENT TO NATIONAL COMMISSION REPORT TO THE ATTORNEY GENERAL, ANTITRUST DEVELOPMENTS 1955-1968, at 211-12 (1968) ("In general where it has appeared that private business advisors have been the real decision makers, state government support has been to no avail.").

their own rules.¹⁰⁹ In most such instances, antitrust violations derive from the particular ways in which the SRO's exercise their delegated authority. Even when the SEC directs an SRO to take a specific action, the directive may be outside the ambit of *Parker* because the SRO rather than the SEC is the real decision-maker. On several occasions SRO's have bargained for positions in which the SEC has ultimately acquiesced through directives.¹¹⁰

As a policy matter, there is little reason to distinguish between SEC approvals and SEC directives. If the Commission has historically neglected competitive factors in approving SRO actions,¹¹¹ it will probably not be moved by such factors in issuing directives.¹¹² As the Commission can evade judicial reversals on review of SEC approvals by building a record of antitrust deliberations, so can it protect itself in the review of SEC directives.¹¹³ Treble damages may seem too harsh for SRO actions mandated by the SEC, but the same applies to SRO actions approved by the Commission.¹¹⁴ Moreover, judicial emphasis on the distinction between SEC approvals and SEC directives would encourage recalcitrance by SRO's in adopting Commission suggestions. Suppose the SEC suggests a regulatory restriction that exchange *A* accepts but exchange *B* rejects, so that the Commission is obliged to issue a directive to exchange *B*. Exchange *B* would be granted antitrust immunity for its recalcitrance, while exchange *A* might be vulnerable to antitrust claims because of its cooperation.¹¹⁵

In short, since SEC directives can be as anticompetitive as SEC approvals of SRO actions, both should be constrained by judicial

109. For example, SEC rule 11b-1, 17 C.F.R. § 240.11b-1(2)(v) (1974), requires an exchange to enact "procedures which provide for the effective and systematic surveillance of the activities of specialists."

110. See generally Note, *supra* note 51, which discusses the bargaining process and concentrates on three examples of its use: floor trading, off-floor trading, and commission rates.

111. See materials cited at note 96 *supra*.

112. The Justice Department's critique of rule 19b-2—the SEC's proposed rule on institutional membership—suggests Commission reluctance to consider antitrust factors in directing SRO action. See Brief of the United States Department of Justice at 21, *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974) [hereinafter Justice Department Brief].

113. See note 98 *supra*.

114. See note 91 *supra* and accompanying text.

115. For example, when the SEC tried to implement an institutional membership rule by voluntary action of the SRO's, the NYSE agreed in principle to the SEC suggestion but other exchanges (such as the PBW) objected. See SENATE STUDY, *supra* note 1, at 81-82. The SEC later directed all exchanges to adopt rule 19b-2. See SEC Securities Exchange Act Release No. 9950, *supra* note 51. If the NYSE had incorporated the SEC suggestion into a rule change, the NYSE would have been open to antitrust attack while the PBW would have been immune.

procedures not weighted toward regulatory goals. But the *Silver* precedent for SRO actions not subject to SEC oversight is becoming irrelevant, and the *Parker* precedent is an inappropriate basis for the view that SRO actions directed by the SEC have antitrust immunity. The key line of precedents is on SRO actions subject to SEC approval, and this line is split on fundamental issues.

2. *The Substantive Tests*

The choice between original federal court jurisdiction over anti-trust claims and initial deference to the SEC raises issues concerning not only the inherent bias of each forum but also the substantive test applicable to allegedly anticompetitive activities in the stock markets.¹¹⁶ Currently, the choice of forum largely determines the substantive test. In deciding an antitrust claim, a court should apply the *Silver* test.¹¹⁷ In reviewing an SEC decision, on the other hand, a court should determine whether the agency properly applied the relevant standards of the 1934 Act.¹¹⁸ These substantive standards are subject to very different interpretations.

a. *The Silver test for antitrust courts.* In *Silver*, the Court extended antitrust immunity "only to the extent necessary to make the Securities Exchange Act work"¹¹⁹ The scope of this test was scarcely explored in *Silver*,¹²⁰ nor was it explicated subsequently in *Kaplan*¹²¹ or *Gordon*.¹²² The *Silver* test was utilized, however, by the court of appeals in *Thill*¹²³ and the district court in *Jacobi v. Bache*.¹²⁴

116. See Jaffe, 77 HARV. L. REV. 1037, *supra* note 29, at 1037-38, 1060-70; Schwartz, *supra* note 29, at 464-71.

117. See text at note 33 *supra*.

118. Securities Exchange Act of 1934, § 19(b), 15 U.S.C. § 78s(b) (1970), requires that Commission action be "necessary or appropriate for protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange" Under section 15A(k)(2), 15 U.S.C. § 78o-3(k)(2) (1970), the Commission may change NASD procedural rules if such action is "necessary or appropriate in the public interest or for the protection of investors or to effectuate the purposes of this section." Under section 15A(h)(1), 15 U.S.C. § 78o-3(h)(1) (1970), the Commission may reverse a disciplinary proceeding of the NASD if it finds that the rule that was violated required "conduct inconsistent with just and equitable principles of trade."

119. See text at note 33 *supra*.

120. See text at note 36 *supra*.

121. See text at notes 72-75 *supra*.

122. See text at notes 81-83 *supra*.

123. See text at notes 76-78 *supra*.

124. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 (S.D.N.Y. 1974). See note 69 *supra*. At least one circuit court has applied the *Silver* test in the parallel area of NASD regulation of the OTC. See *Harwell v. Growth Programs, Inc.*, 451 F.2d 240 (5th Cir. 1971), *rehearing denied*, 459 F.2d 461, *cert. denied*, 409 U.S. 876 (1972),

After suggesting the types of evidence to be considered,¹²⁵ the court in *Thill* gave the district court some guidance in applying the *Silver* test: "[I]t must be established that subjecting the anti-rebate rule to antitrust attack will frustrate the purpose of the Securities Exchange Act or make it substantially ineffective."¹²⁶ This interpretation of *Silver*, like *Silver* itself, has several defects. First, it focuses on the 1934 Act to the neglect of antitrust considerations. No SRO rule would be invalidated so long as it is "necessary" for some regulatory goal, whatever its anticompetitive impact.¹²⁷ Second, it does not specify which goals of the 1934 Act must be frustrated. Despite contrary legislative history,¹²⁸ *Thill* speaks as if the Act had only one purpose. Third, *Thill* is too vague about the nature of the required correlation between SRO rules and the 1934 Act. Phrases like "frustrate the purposes of the Securities Exchange Act" do not provide workable guidelines.¹²⁹

In *Jacobi*, the court interpreted *Silver* as requiring three inquiries. First, the court determined whether the NYSE's action—requiring an add-on service charge for brokerage commissions on exchange transactions but not for representative commissions—was "taken with any anti-competitive purpose."¹³⁰ This inquiry into

discussed in note 83 *supra*. In *Harwell*, the circuit court noted that the record contained little evidence of actual supervision of the disputed rule or consideration of antitrust factors by the SEC. In its main direction to the district court, it merely restated the *Silver* test:

If on remand the proof should show that defendants have taken actions which violate the antitrust laws, and, if in accordance with the principle of *Silver v. New York Stock Exchange* . . . the district court should find that the purposes of the Maloney Act [section 15A of the 1934 Act] do not require that these actions be cloaked with anti-trust immunity, then the mere supervisory presence of the SEC cannot divest the courts of their power to enforce the antitrust laws. 459 F.2d at 462.

125. *Thill* suggests four areas in which factual evidence should be presented: (1) "the effects of the anti-competitive conduct"; (2) the extent to which the rule challenged "is subject to actual review by the SEC"; (3) "what in the regulatory scheme 'performs the antitrust function'"; and (4) why the rule "must be preserved" for the workings of the Act. 433 F.2d at 270.

126. 433 F.2d at 270.

127. The *Thill* court suggested that the challenged anti-rebate rule could hardly be "necessary," since it could be and frequently was evaded by NYSE members. 433 F.2d at 273-74.

128. The purposes of the Exchange Act are manifold. In 1934 Congress focused on dishonesty, manipulation, and insolvency. See R. DEBETS, *THE NEW DEAL'S SEC 56-58* (1964); M. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL 108-44* (1970).

129. A similar criticism can be made of *Harwell v. Growth Programs, Inc.*, 451 F.2d 240 (5th Cir. 1971), *rehearing denied*, 459 F.2d 461, *cert. denied*, 409 U.S. 876 (1972), in which the test was whether "the purposes of the Maloney Act [section 15A of the 1934 Act] do not require that these actions be cloaked with antitrust immunity." 459 F.2d at 462.

130. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 at 96,027.

purpose may be futile because an SRO may easily build a record indicating that it was motivated primarily by regulatory concerns. Second, the court examined whether the SRO practice in fact served a specific regulatory goal of the 1934 Act, laudably tying the SRO practice to a specific statutory mandate to support the financial stability of broker-dealers rather than merely to the nebulous notion of investor protection.¹³¹ Finally, the court looked at the actual impact on competition of the SRO practice. It found that the SRO practice had not limited competition among brokerage firms for the services of registered representatives.¹³² Having determined that the SRO practice served a valid regulatory goal with no anticompetitive effect, the *Jacobi* court did not have to reconcile a conflict between the 1934 Act and the antitrust laws.

b. *The substantive standard for judicial review.* Since the *Silver* Court considered the dispute before it to be beyond the scope of SEC jurisdiction,¹³³ it never faced the issue of the proper standard for judicial review of SEC decisions. Similarly, when the court of appeals affirmed dismissal of the antitrust claim in *Gordon*, it noted that judicial review of the SEC decision could be obtained under the 1934 Act or the APA,¹³⁴ but it did not discuss what substantive test should be applied. Only in *PBW Stock Exchange, Inc. v. SEC*¹³⁵ has the standard for reviewing appeals of SEC decisions been fully debated. While the Justice Department and the SEC agree that under recent case law¹³⁶ the SEC's statutory mandate to protect the public interest requires some analysis of antitrust factors, there is a dispute about the precise importance of such factors.¹³⁷

131. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 at 96,027.

132. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,578 at 96,026.

133. See text at note 40 *supra*.

134. *Gordon v. NYSE*, 498 F.2d 1303, 1311 (2d Cir.), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

135. 485 F.2d 718 (3d Cir. 1973), *cert. denied*, 416 U.S. 969 (1974). At issue in *PBW* is the promulgation by the SEC of rule 19b-2, 17 C.F.R. § 240.19b-2 (1974), which limits institutional membership on the exchanges. The case was dismissed for lack of jurisdiction in the circuit court, but a new complaint has been filed. See note 67 *supra*.

136. Both briefs cite *Denver & Rio Grande W. R.R. Co. v. United States*, 387 U.S. 485 (1966). See SEC Brief, *supra* note 98, at 83; Justice Department Brief, *supra* note 112, at 22. *Denver* involved the duty of the Interstate Commerce Commission to consider whether certain actions were in the "public interest." The Court stated: "Common sense and sound administrative policy point to the conclusion that such broad statutory standards require at least some degree of consideration of . . . anticompetitive consequences. . . . And similarly broad responsibilities are encompassed within like broad directives addressed to other agencies." 387 U.S. at 492-93.

137. This dispute is reflected in analogous cases applying the antitrust laws to other regulated industries. Compare *McLean Trucking Co. v. United States*, 321 U.S. 67 (1944), with *Federal Maritime Bd. v. Isbrandtsen Co.*, 356 U.S. 481 (1958).

The Justice Department's argument is bottomed on footnote sixteen of *Silver*, which states that "any rule that might be adopted by the Commission would, to be consonant with the antitrust laws, have to provide as a minimum the procedural safeguards which those laws make imperative in cases like these."¹³⁸ From this footnote, the Justice Department infers that an SEC decision "in order to be 'consonant with the antitrust laws' must provide *all* the safeguards which the antitrust laws 'make imperative' in such cases."¹³⁹ The phrase "to the minimum extent necessary" used in *Silver*,¹⁴⁰ the argument goes, requires not only that the SEC action be necessary for the 1934 Act but also that it be the least anticompetitive alternative.¹⁴¹ This argument, however, has two weak links.¹⁴² First, footnote sixteen of *Silver* can easily be read to require only the provision of procedural safeguards for all SEC decisions, rather than adherence to all of the substantive standards of the antitrust laws.¹⁴³ Second, the *Silver* test can reasonably be read to mean only that the antitrust laws are to be repealed "to the minimum extent necessary."¹⁴⁴ Moreover, by requiring the least anticompetitive alternative the Justice Department would be applying a stiffer test to the stock markets, a semi-regulated industry, than the rule of reason¹⁴⁵ used in antitrust cases involving even nonregulated industries.¹⁴⁶

138. 373 U.S. at 364 n.16. See Justice Department Brief, *supra* note 112, at 24.

139. Justice Department Brief, *supra* note 112, at 24 (emphasis original).

140. See text at note 33 *supra*.

141. Justice Department Brief, *supra* note 112, at 33, 35.

142. Outside counsel to the NYSE argues that the Justice Department's view of the necessity test is "without any support." Letter from William E. Jackson, Esq., to James J. Needham, NYSE Chairman, March 14, 1974, at 6.

143. The Justice Department recognizes this problem, but argues: "Such safeguards include not only the procedural requirements emphasized by the Supreme Court in *Silver*, but also the traditional competitive requirements . . ." Justice Department Brief, *supra* note 112, at 24.

144. SEC Brief, *supra* note 98, at 83-84.

145. Where the rule of reason applies, any constraint on competition must be judged in light of its surrounding context. A. NEALE, *ANTITRUST LAWS OF THE U.S.A.* 20-27 (2d ed. 1970). As Justice Brandeis explained in *United States v. Chicago Bd. of Trade*, 246 U.S. 231, 238 (1918):

The legality of an agreement or regulation cannot be determined by so simple a test, as whether it restrains competition. Every agreement concerning trade, every regulation of trade, restrains. . . . The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the Court must ordinarily consider the facts peculiar to the business to which the restraint is applied . . . , the nature of the restraint and its effect, actual and probable.

On the other hand, the courts have applied per se rules of illegality to certain categories of competitive constraints. A. NEALE, *supra*, at 27-29. Under per se rules, constraints are deemed illegal regardless of asserted justifications. See, e.g., *United States v. Topco Associates, Inc.*, 405 U.S. 596 (1972).

146. As a hypothetical example, assume the merger of two competing exchanges

In contrast, the SEC takes the position that the *Silver* test is automatically met by its decisions: "Our unfettered ability to exercise the broad regulatory authority vested in us, and the necessity of exchange compliance with the Commission's regulatory determinations, are, by any calculation, 'necessary to make the Securities Exchange Act work . . .'"¹⁴⁷ The SEC cites cases involving regulated industries in which agencies were given wide latitude by the reviewing courts in evaluating competitive factors,¹⁴⁸ and concludes that it should be allowed to take action inconsistent with the antitrust laws "whenever it believes such action is 'necessary or appropriate' to protect the public interest and carry out the fundamental policies underlying the Securities Exchange Act."¹⁴⁹ This argument is less than persuasive. The SEC's elastic definition of "necessity" would eliminate any judicial analysis of competitive factors in the stock markets, reducing the regulatory inquiry to the existence of SEC jurisdiction over the subject matter¹⁵⁰ despite cases involving agency decisions on regulated industries in which the courts considered antitrust factors paramount.¹⁵¹ Most importantly, the standard proposed by the SEC is couched in subjective terms, giving virtually limitless discretion to the SEC in regulating the stock markets.¹⁵²

to achieve economies of scale. See, e.g., *NYSE Group To Study Pacific Exchange Links*, BNA SEC. REG. & L. REP. No. 221, at A-3 (Oct. 3, 1973). Under the Justice Department's approach, the exchanges would have to prove as an affirmative defense to an antitrust suit that the merger was necessary for 1934 Act purposes and that such purposes could not be achieved by more competitive means, such as pooling of certain resources. However, if the exchanges were not regulated, the merger might be allowed without proof that a less competitive alternative existed. The Supreme Court has not yet required, especially in the area of regulated industries, that mergers be barred simply because the same result could have been achieved by some more competitive alternative. See, e.g., *United States v. Marine Bancorporation, Inc.*, 418 U.S. 602 (1974). Cf. *United States v. Falstaff Brewing Corp.*, 410 U.S. 526, 537 (1973).

147. SEC Securities Exchange Act Release No. 9950, *supra* note 51, at 186.

148. SEC Brief, *supra* note 98, at 84 n.214. The only Supreme Court case cited is *McLean Trucking Co. v. United States*, 321 U.S. 67 (1944).

149. SEC Brief, *supra* note 98, at 84.

150. The subject matter jurisdiction of the SEC is expansive. See text at notes 42-58 *supra*.

151. See *Federal Maritime Commn. v. Aktiebolaget Svenska Amerika Linien*, 390 U.S. 238 (1968); *Federal Maritime Bd. v. Isbrandtsen Co.*, 356 U.S. 481 (1958). See also *Federal Maritime Commn. v. Seatrain Lines, Inc.*, 411 U.S. 726 (1973); *United States v. El Paso Natural Gas Co.*, 376 U.S. 651 (1964); *United States v. Philadelphia Natl. Bank*, 374 U.S. 321 (1963); *California v. FPC*, 369 U.S. 482 (1962).

152. For an eloquent critique of unfettered administrative discretion, see K. DAVIS, *DISCRETIONARY JUSTICE* (1969). For a survey of the case law on decisions committed to agency discretion, see K. DAVIS, *ADMINISTRATIVE LAW TEXT* § 28.05 (3d ed. 1972) [hereinafter DAVIS TEXT].

B. The Legislature

Since the courts have not reached a definitive decision on the proper forum or substantive standard for reconciling the antitrust laws with the 1934 Act, this might be an excellent area for legislative clarification. In the past session of Congress, the Senate passed a series of bills concerning the regulation of the stock markets that stand a good chance of passage in the present Congress.¹⁵³ Unfortunately, the proposed legislation fails to resolve the basic issues left open by the case law. As a result, the legislation would virtually assure that conflicts between antitrust laws and the 1934 Act would be reviewable simultaneously in two different forums under two different standards.

1. Choice of Forum

The proposed legislation expands the scope of SEC jurisdiction and judicial review to such a degree that all future cases will probably fall within the area unresolved by *Silver*.¹⁵⁴ It would permit the SEC to review rule changes¹⁵⁵ as well as disciplinary hearings¹⁵⁶ by exchanges, and to alter all substantive and procedural rules of the NASD,¹⁵⁷ as well as of the exchanges.¹⁵⁸ It gives the SEC power to obtain an injunction against nonenforcement of SRO rules,¹⁵⁹ and to impose its own rules in areas beyond the scope of its current authority.¹⁶⁰ The new legislation would provide for judicial review of more SEC decisions by the courts of appeals under section 25 of the

153. See note 19 *supra*.

154. The area of SEC jurisdiction and ensuing judicial review has already been greatly expanded by the courts. See text at notes 41-67 *supra*.

155. S. 249, 94th Cong., 1st Sess. § 15 (1975); H.R. 10, 94th Cong., 1st Sess. § 202 (1975). The Commission may currently review NASD rule changes, but not exchange rule changes. See note 13 *supra*.

156. S. 249, 94th Cong., 1st Sess. § 15 (1975); H.R. 10, 94th Cong., 1st Sess. § 202 (1975). The SEC currently is empowered to review NASD disciplinary proceedings, but not exchange disciplinary proceedings. See note 14 *supra*.

157. S. 249, 94th Cong., 1st Sess. § 15 (1975); H.R. 10, 94th Cong., 1st Sess. § 203 (1975). The SEC currently has direct power to amend NASD rules in four procedural categories. See note 12 *supra*.

158. S. 249, 94th Cong., 1st Sess. § 15 (1975); H.R. 10, 94th Cong., 1st Sess. § 203 (1975). The Commission can now amend exchange rules in twelve substantive areas plus "similar matters." See note 12 *supra*.

159. S. 249, 94th Cong., 1st Sess. § 16 (1975); H.R. 10, 94th Cong., 1st Sess. § 206 (1975). Currently, the SEC can arguably obtain enforcement of SRO rules by a circuitous route based on sections 6 and 20 of the 1934 Act. See note 55 *supra*.

160. The legislation gives the SEC more direct authority over certain areas of the market, such as dealer practices in the OTC. S. 249, 94th Cong., 1st Sess. § 11 (1975); H.R. 10, 94th Cong., 1st Sess. § 205 (1975). Similarly, the legislation gives the SEC power over other market participants, such as clearing agencies. S. 249, 94th Cong., 1st Sess. § 14 (1975); H.R. 10, 94th Cong., 1st Sess. § 404 (1975).

1934 Act and by the district courts under the APA,¹⁶¹ including judicial review of most SEC decisions requiring or inducing actions by SRO's.¹⁶²

This expansion of SEC jurisdiction over SRO activity and of judicial review of SEC decisions could be viewed as a legislative resolution of the procedural question reserved by *Silver*. All conflicts between the antitrust laws and the 1934 Act could be litigated as challenges to SEC decisions in the courts of appeals. The legislative history of the bills, however, strongly supports the existing precedents for jurisdiction by antitrust courts over SRO actions. The Senate Report states: "In the Committee's view, it is essential that the antitrust courts retain their jurisdiction to make the ultimate accommodation between antitrust principles and the powers and actions of the self-regulatory organizations."¹⁶³ Moreover, the Senate Report goes further than existing case law, which does not include any successful antitrust suits against SRO actions directed by the SEC.¹⁶⁴ The Report says that original jurisdiction by antitrust courts should be permitted irrespective of whether self-regulatory conduct "has been approved or required by the SEC . . ."¹⁶⁵ Thus, instead of resolving the procedural question left open by *Silver*, the proposed legislation confuses matters further.

2. *The Substantive Test*

Having established two separate forums for deciding conflicts between the antitrust laws and the 1934 Act, the proposed legislation lays down a different substantive test for each forum. Where antitrust courts have original jurisdiction, the proposed legislation explicitly retains the *Silver* test as if its meaning were clear. The Report embraces "the basic principle enunciated in *Silver* that no repeal of

161. S. 249, 94th Cong., 1st Sess. § 19 (1975); H.R. 10, 94th Cong., 1st Sess. § 203 (1975). For the current distinctions between review under section 25 and APA review, see text at notes 61-65 *supra*.

162. S. 249, 94th Cong., 1st Sess. § 19 (1975); H.R. 10, 94th Cong., 1st Sess. § 203 (1975). For the current problems in obtaining judicial review of SRO actions induced or imposed by the SEC, see notes 66-67 *supra*.

163. REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, NATIONAL SECURITIES MARKET SYSTEM ACT OF 1974, S. REP. NO. 93-865, 93d Cong., 2d Sess. 11 (1974) [hereinafter NATIONAL MARKET REPORT]. Although the Report deals with legislation introduced in the Ninety-third Congress, it is applicable to the new legislation, which consolidates the bills passed by the Senate in its last term. See note 19 *supra*. The report accompanying the consolidation bill is merely a summary. REPORT OF THE SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, SUMMARY OF PRINCIPAL PROVISIONS OF SECURITIES ACTS AMENDMENTS OF 1975, S. 249, 94th Cong., 1st Sess. (1975).

164. See text at notes 104-08 *supra*.

165. NATIONAL MARKET REPORT, *supra* note 163, at 11 (emphasis added).

the antitrust laws with respect to the conduct of self-regulatory organizations would be implied unless such repeal were 'necessary to make the Exchange Act work, and even then only to the minimum extent necessary.'"¹⁶⁶ Yet the legislation implicitly rejects the interpretations given the *Silver* test by both the SEC and the Justice Department. Since the Senate Report envisages a judicial inquiry into the "necessity" of SRO conduct, regardless of approval or direction from the SEC, it does not equate SEC action with fulfillment of the *Silver* test.¹⁶⁷ On the other hand, since the Senate Report says that SRO conduct should not constitute an "unreasonable restraint on competition,"¹⁶⁸ it seems to favor the rule of reason used in prior antitrust cases rather than the "least anticompetitive alternative" approach urged by the Justice Department.¹⁶⁹

Whatever the standard it embraces for original actions in antitrust courts, the proposed legislation delineates a different standard for judicial review of SEC decisions: "necessary or appropriate" in the public interest or for the protection of investors.¹⁷⁰ The use of the words "or appropriate" provides a more lenient standard for judging anticompetitive activity in the stock markets than the *Silver* "necessity" test.¹⁷¹ In contrast to its naive embrace of the *Silver* test for use by the antitrust courts, however, the Report laudably attempts to give economic content to the "necessary or appropriate" standard: "Under all these sections, the SEC's responsibility would be to balance the anti-competitive effects of the regulatory policy or decision at issue against the purposes of the Exchange Act that would be advanced thereby and the costs of doing so."¹⁷²

In sum, having increased the probability of simultaneous decisions on the same dispute in two judicial forums, the proposed legislation emphasizes the differences in the substantive tests for reconciling the antitrust laws with the 1934 Act in each forum. As a result, a district court might strike down an SRO action as an antitrust violation under the *Silver* "necessity" test, while a court of appeals

166. *Id.*, quoting *Silver v. NYSE*, 373 U.S. 341, 357 (1963).

167. The SEC contends that its decisions automatically meet the *Silver* test. See text at notes 147-49 *supra*.

168. NATIONAL MARKET REPORT, *supra* note 163, at 11.

169. See text at note 141 *supra*.

170. S. 249, 94th Cong., 1st Sess. §§ 15, 17 (1975).

171. The standard for judicial review was "reasonably necessary" in the early drafts of the new legislation, but was changed to "necessary or appropriate" in the final version. Compare S. 2519, 93d Cong., 1st Sess. §§ 18, 20 (1973) with S. 249, 94th Cong., 1st Sess. §§ 15, 17 (1975). But the "necessary or appropriate" standard has always been part of the 1934 Act. See note 118 *supra*.

172. NATIONAL MARKET REPORT, *supra* note 163, at 10.

might uphold the SEC's approval of the same SRO action as "appropriate" to the 1934 Act. The prime saving grace of the legislation is its attempt to define the "necessary or appropriate" standard in meaningful economic terms.

II. AN ECONOMIC APPROACH TO TRANSACTIONAL SERVICES

Since both the courts and Congress have failed to develop satisfactory procedures or criteria for resolving conflicts between antitrust laws and the 1934 Act, this section will suggest a different approach. It begins by describing an economic model of the stock market as a service industry for facilitating stock transactions. It then derives from that model a new substantive test for reconciling competition and regulation in the stock market, starting with the stringent assumptions of perfect competition and going on to deal with the main deviations from these assumptions in the actual market. Finally, this section outlines procedures for implementing the new substantive test, which delineate important roles for the Justice Department, Congress, the SEC, and the courts.

A. *The Development of a New Substantive Test*

1. *The Stock Market as a Service Industry*

Stock¹⁷³ represents the right to a proportionate share of future corporate income.¹⁷⁴ Stock markets¹⁷⁵ provide the medium through which investors may trade their rights to future corporate income

173. Corporations obtain investment capital by selling stock to the public (a so-called "primary distribution"). For a survey of the distribution process and the application of the Securities Act of 1933, 15 U.S.C. §§ 77e-h (1970), to primary distributions, see W. CARY, *CORPORATIONS: CASES AND MATERIALS* 1287-477 (1969). Corporations also obtain investment capital from sources other than the sale of common stock—most importantly, retention of corporate earnings and sale of corporate bonds. See 37 SEC ANN. REP. 218 (1971).

174. Corporate income may be paid out as dividends or retained by the corporation for investment. The latter course may not only appreciate the value of the shareholder's stock, but may also offer more favorable long-run tax treatment. See generally V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE: CASES AND MATERIALS* 419-44 (1972). Stock also represents the right to a proportionate share of corporate assets upon liquidation, but this aspect need not be considered here.

175. The stock markets (e.g., the NYSE and the OTC) are secondary trading markets, on which previously issued stock is traded among investors. Secondary markets permit investors the liquidity necessary to attract investment capital to the primary distribution of securities. Similarly, prices in the secondary market influence prices set by corporate offerors in a distribution of new securities. See R. ROBINSON & D. WRIGHTSMAN, *FINANCIAL MARKETS: THE ACCUMULATION AND ALLOCATION OF WEALTH* 11-12 (1974). Secondary trading far exceeds the volume and value of primary distributions. Between 1960 and 1973, for example, new issues of corporate stock totaled only \$13.6 billion, or less than 8 per cent of the \$178 billion volume on exchange markets alone. NYSE FACT BOOK, *supra* note 1, at 17, 68.

for cash or other securities.¹⁷⁶ Stock transactions are facilitated by three main services: dissemination of current information on stock prices,¹⁷⁷ market making to offset temporary imbalances in orders,¹⁷⁸ and a clearing process for consummated trades.¹⁷⁹ Ancillary stock transaction services include research on stock performance¹⁸⁰ and the holding of stock certificates by brokers.¹⁸¹

Like other service industries, the facilitation of stock transactions can be analyzed in terms of supply and demand.¹⁸² At the retail level,¹⁸³ brokerage houses supply transactional services through outlets established in most American cities. While all brokerage houses have similar cost items (e.g., office rent, salaries, and processing equipment),¹⁸⁴ overall costs may vary according to such factors as office

176. See Demsetz, *The Cost of Transacting*, 82 Q. J. ECON. 33, 35 (1968).

177. Price reports on recent stock trades are provided by ticker tapes, the largest of which are operated by the NYSE and AMEX. Regional exchanges (e.g., the Midwest Stock Exchange) have tapes with relatively small distributions; the OTC has no tape. SENATE STUDY, *supra* note 1, at 96.

The NYSE and AMEX also have the largest "quote systems," whereby price reports on current offers ("quotations") are communicated. The OTC's elaborate quote system is called NASDAQ. See SENATE STUDY, *supra*, at 97, 103; note 5 *supra*.

178. Market making is the willingness of dealers to carry stock inventories sufficient to absorb temporary imbalances in the flow of buy and sell orders. See generally R. WEST & S. TUNIC, *THE ECONOMICS OF THE STOCK MARKET* 143 (1971).

179. For a general discussion of the transfer of ownership process, see HOUSE STUDY, *supra* note 7, ch. VIII.

180. For a discussion of the legal and economic aspects of research, and advice based upon research, see SENATE STUDY, *supra* note 1, at 60-62; Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604 (1971).

181. See Guttman, *Broker-Dealer Bankruptcies*, 48 N.Y.U. L. REV. 887, 890-93 (1973).

182. The arguments of the NYSE often imply that the usual economic laws of supply and demand do not apply to stock markets. Arguing for fixing intramember rates, the NYSE stated:

A critical problem associated with changes in the number of active floor brokers is that declines tend to be irreversible. This occurs as a result of the fact that only a limited number of individuals are qualified for these positions at any particular time. As departing brokers commit themselves to other endeavors, the replacement rate at peak demand periods will fall below the departure rate in inactive periods. Thus, if declining floor brokerage rates due to competitive pressures when volume was low thinned the ranks of independent floor brokers, the loss in capacity would probably never be fully made up, even at a later date when higher volume levels might stimulate higher rates.

NYSE, *The Need for Fixed Floor Brokerage Rates* 14-15 (May 29, 1974) (report submitted to the SEC).

The NYSE argument ignores certain basic economic principles. It is true that as floor brokerage profits decline in a period of low volume, floor brokers will leave the exchange. However, rising profits accompanying a period of high volume will induce the entry of new floor brokers. That "the loss in capacity would probably never be fully made up" is explained by the barriers imposed by NYSE regulatory restrictions. If the NYSE allowed floor brokers immediate entry into the business, or maintained a pool of qualified floor brokers, high volume would induce the return of floor brokers so long as profits from this line of business exceed those available elsewhere.

183. "Retail" here denotes broker transactions with public investors. "Wholesale" transactions describe those among brokers and dealers and other market professionals.

184. See I. FRIEND & M. BLUME, *THE CONSEQUENCES OF COMPETITIVE COMMISSIONS OF*

location,¹⁸⁵ type of investor serviced,¹⁸⁶ and efficiency of operation.¹⁸⁷ At the wholesale level, the stock markets provide member firms with central facilities for disseminating price information, executing trades, and transferring ownership of securities. Each marketplace is organized as a users' cooperative¹⁸⁸ owned by brokers who pay fees to cover operating costs and who share pro rata any annual profits.

Exchanges and the OTC are different types of stock markets. In a stock exchange, one specialist maintains price quotations in each stock in return for the exclusive right to trade that stock on the exchange floor.¹⁸⁹ Orders¹⁹⁰ received by member firms are transmitted via floor brokers to the specialist's post. There public orders are matched with other public orders or with the specialist's own inventory at the current price quotation.¹⁹¹ Unmatched "market" orders are generally returned to the investor; "limit orders" are retained by the specialist for future matches.¹⁹² By contrast, the OTC is not limited to single specialists with exclusive trading rights.¹⁹³ Numerous dealers may make offers for trades through a computerized quote system or through daily "pink sheets."¹⁹⁴ The price and volume of trades are then negotiated by phone. An OTC firm may negotiate a trade on behalf of a customer with the dealer offering the best quotation, much as the exchange member sends orders to the spe-

THE NEW YORK STOCK EXCHANGE 267-79 (1972), reprinted in *Hearings on S. 3169 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 267-318 (1972) [hereinafter *Hearings on S. 3169*]; R. WEST & S. TINIC, *supra* note 178, at 123-39.

185. See I. FRIEND & M. BLUME, *supra* note 184, at 276-79.

186. See *id.*

187. For a summary of the studies on the efficiency of different types of brokerage firms, see SENATE STUDY, *supra* note 1, at 52-53.

188. See Baxter, *supra* note 16, at 705.

189. See generally Wolfson, Rosenblum & Russo, *supra* note 1, at 810-21.

190. There are two main types of orders—market and limit orders. A market order is for sale or purchase at the current price. A limit order is for sale or purchase at a specified price only.

191. If there is no public match, the specialist is under a loosely defined obligation to effect a match from his inventory at the current price. See, e.g., NYSE Rule 104, 2 CCH NYSE GUIDE ¶ 2104 (1975). For criticism of such rules, see *Securities Industry Study, Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. 18-21 (1972) [hereinafter *Securities Industry Study*]. Cf. note 199 *infra*.

192. See note 190 *supra*.

193. See generally 2 L. Loss, *supra* note 53, at 1277-87.

194. For a description of the computerized quotation system (NASDAQ), see note 5 *supra*. The daily "pink sheets" are sent to broker-dealers in the OTC and are published in newspapers.

cialist on an agency basis. Alternatively, an OTC firm may buy or sell shares directly with the customer, in a fashion similar to the specialist who deals in his own inventory.¹⁹⁵

Two principal categories of investors purchase transactional services: institutions and individuals. Institutional investors own about forty-five per cent of the market value of all NYSE-listed stocks,¹⁹⁶ and have a turnover rate in shares more than twice that of individual investors.¹⁹⁷

Investors of both types want the lowest possible transaction costs: that is, the narrowest spread (the difference between the buy and sell prices offered simultaneously by a dealer) necessary for market making and the lowest charge for using transactional facilities.¹⁹⁸ In an exchange, an investor pays the specialist's spread unless the investor's order is matched with another public order.¹⁹⁹ In the OTC, the investor always pays the spread, either to another dealer in an agency execution or to the OTC broker trading for his own account. In an exchange, the user charge is the commission²⁰⁰—a fee for the broker's facilities and for exchange facilities (floor brokerage).²⁰¹ In

195. See R. WEST & S. TINIC, *supra* note 178, at 51-54.

196. The NYSE says that the holdings of financial institutions comprise 31.4 per cent of the market value of all NYSE-listed stock, excluding nonregistered mutual funds, investment partnerships, nonbank trusts, foreign institutions, and bank trust funds. If the estimated holdings of these financial institutions were added, institutions would own over 45 per cent of the NYSE list. NYSE FACT BOOK, *supra* note 1, at 52. Of the institutional portfolios, the largest are held by bank trust funds, pension funds, mutual funds, insurance companies, and foundations, listed in descending order. See *id.*; INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMM., H.R. DOC. NO. 64, 92d Cong., 1st Sess. 414, 430 (1971) [hereinafter INSTITUTIONAL INVESTOR STUDY].

Eighteen million individuals own the remaining 55 per cent of NYSE-listed stock. NYSE, A DETAILED LOOK AT THE INDIVIDUAL INVESTOR 3 (1970) [hereinafter DETAILED LOOK].

197. In 1971, for example, the total value of trades in NYSE-listed stocks was divided as follows: 52.4 per cent by institutional investors, 24.4 per cent by individuals, and 23.2 per cent by NYSE members. A comparison of turnover rates must also take into account the fact that institutional investors own 10 per cent less stock by value than individual members. See note 196 *supra*.

198. Demsetz, *supra* note 176, at 35. Demsetz says that the spread consists of about 40 per cent transaction costs and about 60 per cent brokerage fees. *Id.* at 40.

199. Only about six per cent of all exchange orders are matched with other public orders in the so-called "crowd" in front of the specialist's desk. See Blumenthal, *The Development of the Central Market System: Revolution—One Step at a Time*, 3 RUTGERS J. COMPUTERS & L. 232, 238-40 & n.21 (1974).

200. For a discussion of commission charges on exchanges, see Ratner, *Regulation of the Compensation of Securities Dealers*, 55 CORNELL L. REV. 348, 350-54 (1970).

201. For a discussion of floor brokerage, see SEC Securities Exchange Act Release No. 10751 (April 23, 1974) [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,764. Floor brokerage is usually paid to the floor broker for executing a trade, but is given to the specialist for holding a limit order if that order is ultimately matched with another public order. See generally text at notes 190-92 *supra*.

the OTC, there is no floor brokerage.²⁰² The OTC firm that negotiates a trade for a customer charges a commission for use of its facilities; the OTC firm that trades for its own account directly with a customer buries the user charge in the spread for the dealer function.

2. *Perfect Competition and the Revised Silver Test*

We may begin by positing a market for stock transactions that satisfies the central assumptions of perfect competition:²⁰³ (1) suppliers provide a homogeneous commodity or service; (2) producers and consumers are numerous in relation to the size of the market; (3) perfect information about market choices is available; (4) barriers to entry are absent; and (5) external effects imposed by parties on others without compensation are absent.²⁰⁴

Under these assumptions, the market for stock transactions would be efficient²⁰⁵ without any governmental restrictions. Each broker would compute its internal costs as well as the cost of using the relevant marketplaces for various types of transactions; each investor would seek out the brokerage firm providing the narrowest spread and lowest user charge for the desired stock transactions. Through the interplay of supply and demand, prices for each type of transactional service would equal the marginal cost of supplying the last unit of that service.²⁰⁶ Such operational efficiency in transactional

202. See Letter from Bache & Co. to Stan West, NYSE Assistant Vice-President, Nov. 9, 1973, in *Hearings on S. 2519 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. 500-01 (1973).

203. See generally F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 8-11 (4th ed. 1973). Implicit in the concept of perfectly competitive markets are certain assumptions about individual consumers and suppliers. Individuals are assumed rationally to maximize utility functions, which are continuous and convex. Similar assumptions apply to producers. See Polinsky, *Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law*, 87 HARV. L. REV. 1655, 1666-69 (1974).

204. The first four assumptions are discussed in J. HENDERSON & R. QUANDT, *MICRO ECONOMIC THEORY: A MATHEMATICAL APPROACH* 104-05 (2d ed. 1971). For a description of externalities, see P. SAMUELSON, *ECONOMICS*, 474-76 (9th ed. 1973).

205. Efficiency is defined for a given income distribution as a state at which it would be impossible to rearrange resources so that those who gain by rearrangement would be better off if they were to compensate those who lose by rearrangement. See Polinsky, *supra* note 203, at 1663-64. In other words, neither brokers nor investors could alter the arrangement of transactional services without causing more harm to others than benefit to themselves.

206. As a practical matter, these equilibrium prices would probably be reflected in a set of schedules for different types of transactional services offered by brokerage firms. See, e.g., Cole, *Wall Street's "Negotiated Rates" Plans Start Today*, N.Y. Times, April 1, 1974, at 49, cols. 3-7 (late city ed.) (schedules published during the experimental phase on competitive commission rates for small transactions).

For the characteristics of a long-run competitive equilibrium, see F. SCHERER, *supra* note 203, at 13.

services²⁰⁷ is a necessary but not sufficient condition for allocational efficiency²⁰⁸ in the broader market for investment capital. To allocate investment capital efficiently, stock prices should reflect long-run projections of corporate income.²⁰⁹ When new information about projected corporate income is revealed, the price of a company's shares should adjust quickly to the appropriate level.²¹⁰ Investors will not alter their positions in response to the new information about projected corporate income, however, if the cost of transacting in that stock exceeds the value of the new information to the investors.²¹¹

Under these assumptions, competitive adjustment of the market for stock transactions would also entail lower administrative burdens than any regulatory restriction. The interplay of market forces would correct any short-term deviation from operational efficiency.²¹² For example, changes in the demand function of buyers would lead to price changes and adjustments in the amount of services supplied, until marginal cost again equals price.²¹³ At the same time, the competitive process would maximize individual choice and minimize bureaucratic constraint.²¹⁴ The government's role would be confined mainly to the judicial enforcement of contracts.²¹⁵

The extent of the costs imposed by a regulatory restriction²¹⁶ on the market for transactional services would depend on the type and incidence of that restriction. Regulations to maintain price fixing

207. See I. FRIEND & M. BLUME, *supra* note 184, at 335-36.

208. See *id.* at 336-38.

209. For a discussion of long-term allocational efficiency and prices in stock markets, see W. BAUMOL, *THE STOCK MARKET AND ECONOMIC EFFICIENCY* 35-36 (1965). For a discussion of short-term price movements in the stock markets and their relation to allocational efficiency, see R. WEST & S. TINIC, *supra* note 178, at 26-42.

210. There is considerable evidence that new information is assimilated rapidly by the stock markets through changes in stock prices. For a relatively basic introduction to the relevant studies, see Fama, *Random Walks in Stock Market Prices*, 21 *FIN. ANAL. J.*, Sept.-Oct. 1965, at 55. For a comprehensive survey of the empirical and theoretical literature in this field, see Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 *J. FIN.* 383 (1970).

211. R. WEST & S. TINIC, *supra* note 178, at 176. Of course, there may be other reasons why changes in the future potential for corporate earnings may not be reflected rapidly in price changes on the stock markets, such as the withholding of inside information. For this reason operational efficiency is a necessary but not sufficient condition for allocational efficiency.

212. See P. SAMUELSON, *supra* note 204, at 385-86.

213. Cf. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 1-2 (1973).

214. Blake & Jones, *In Defense of Antitrust*, 65 *COLUM. L. REV.* 377, 382-83 (1965).

215. Cf. L. FRIEDMAN, *CONTRACT LAW IN AMERICA* 23 (1965).

216. Regulatory restrictions include all rules of SRO's and the SEC that prohibit or constrain the behavior of investors, brokers, or other market participants.

(*e.g.*, minimum commission rates)²¹⁷ impose both large efficiency losses and administrative expenses. Changes in demand for services and cost to suppliers require price fluctuations; a fixed rate would never be efficient in fully competitive markets. To ensure that investors and brokers do not circumvent a fixed rate, some administrative body must guard against black markets and kickback schemes.²¹⁸ Trading restrictions on marketplaces tend to impose relatively high efficiency losses and relatively low administrative expenses because there are so few marketplaces. For instance, if the SEC withdrew the right of a regional exchange to trade in a NYSE-listed stock, the removal of a computing specialist might lead to wider spreads for market making on other exchanges,²¹⁹ although the SEC could easily enforce the trading prohibition at the regional exchange.²²⁰ Since the securities industry contains many brokers, restrictions on brokerage activity tend to impose relatively low efficiency losses and relatively high administrative expenses. A good example is the net capital rule, which requires all brokers to maintain a certain ratio of capital reserves to aggregate indebtedness.²²¹ While this rule may impose a legal barrier to entry for some potential brokers²²²—thereby decreasing competition for investor orders²²³—these efficiency losses will be relatively low in cities with many brokerage firms. But the net capital rule has spawned a complex set of administrative problems in interpreting minimum standards and applying them to a diverse group of brokerage firms on a regular basis.²²⁴

Efficiency losses and administrative expenses imposed by a regulatory restriction would generally be passed on to investors in the form of higher prices for transactional services. For instance, a regulatory restriction of trading to one marketplace permits specialists at that marketplace to reap excess profits in the form of wide spreads paid by investors.²²⁵ The extra administrative cost of any

217. See Ratner, *supra* note 200, at 350-54.

218. See, for example, the discussion of the various schemes to avoid the NYSE's fixed commission rates in INSTITUTIONAL INVESTOR STUDY, *supra* note 196, at 2182-89.

219. See text at note 225 *infra*.

220. The SEC has well-established procedures for granting or denying unlisted trading privileges to exchanges. See SENATE STUDY, *supra* note 1, at 129-33.

221. Securities Exchange Act of 1934, § 15(c)(3), 15 U.S.C. § 78o(c)(3) (1970).

222. Cf. R. POSNER, *supra* note 213, at 126-27.

223. For a discussion of the economic effects of minimum entry standards for professions, see W. GELLHORN, INDIVIDUAL FREEDOM AND GOVERNMENTAL RESTRAINTS 106-18 (1956); T. SCITOVSKY, WELFARE AND COMPETITION 426 (1951). See generally J. BAIN, BARRIERS TO NEW COMPETITION (1956).

224. See, *e.g.*, HOUSE STUDY, *supra* note 7, at 25-30; SENATE STUDY, *supra* note 1, at 29-32.

225. See I. FRIEND & M. BLUME, *supra* note 184, at 352-54; R. WEST & S. TINIC, *supra* note 178, at 162.

regulatory activity undertaken by SRO's is financed in large part by assessments paid by member firms according to the amount of their commissions.²²⁶ The assessments become part of the cost basis by which brokers compute user charges for their services. The SEC finances its administration of the stock markets by levying a registration tax on each marketplace based on the dollar value of stocks traded at that marketplace.²²⁷ This tax also is passed on to investors.²²⁸ To the extent that the revenues from the registration tax offset the SEC's congressional appropriation, the SEC's expenses for regulating the stock markets are effectively borne by investors.

The foregoing discussion implies that regulatory restrictions designed to promote the purposes of the 1934 Act should be judged according to the following revised *Silver* test: *A regulatory restriction should be validated only if its regulatory benefits outweigh the efficiency losses and administrative expenses imposed by the restriction.* Although new procedures would be required to generate the data for the application of this test,²²⁹ it is superior to the current approach. The test is based neither on an ambiguous footnote in a Supreme Court decision nor on a semantic explication of the word "necessity."²³⁰ It is derived from an economic model of the stock markets. In contrast to the substantive tests proposed by the Justice Department and the SEC,²³¹ it does not resolve the underlying tension between competition and regulation wholly in favor of either competition or regulation. Rather, it requires a balancing of all relevant costs and benefits. The revised test does not distinguish between judicial review and original antitrust suits or between conduct directed by the SEC and conduct approved by the SEC.²³² Any

226. For example, NYSE members are liable for an assessment not in excess of "one per cent of the difference between the gross commission charged by the member, member firm or member corporation . . . and the commissions payable by such member" NYSE Const. art. X, § 2. Cf. BOSTON STOCK EXCH. RULES c. XXIII, § 3; NASD MANUAL, ¶ 1301A, sched. A, § 1(b).

SRO's impose uniform dues of limited amounts. See NYSE Const. art. X, § 1; Boston Stock Exchange art. III, § 2; NASD MANUAL ¶ 1301A, sched. A, § 1(a). Exchanges also impose substantial fees on corporations whose stock is listed for trading on that marketplace. See, e.g., NYSE, Schedule of Listing Fees (effective Nov. 18, 1974). The NASD has recently proposed that companies listed on NASDAQ pay listing fees. BNA SEC. REG. & L. REP. No. 247, at A-12 to -13 (April 10, 1974).

227. Securities Exchange Act of 1934, § 31, 15 U.S.C. § 78ee (1970). Although this tax does not currently apply to the OTC, it would apply under the proposed legislation. See S. 249, 94th Cong., 1st Sess. § 21 (1975).

228. See *Rosin v. NYSE*, 484 F.2d 179 (7th Cir. 1973), cert. denied, 415 U.S. 977 (1974).

229. See section IIB *infra*.

230. See text at note 33 *supra*.

231. See text at notes 139-41, 147-49 *supra*.

232. See text at notes 71-115 *supra*.

regulatory restriction on the stock markets may impose efficiency losses and regulatory expense; the revised test provides a single substantive standard by which to test all such restrictions.

3. *The Revised Silver Test in the Real World of Stock Transactions*

Because the revised *Silver* test is derived from a model of perfect competition, it is relevant to ask whether it can be sensibly applied in the real world of stock transactions. Two criticisms of the new test are likely to be made. First, the actual market for stock transactions may deviate from one or more of the assumptions behind the model of perfect competition, suffering from what may be called market imperfections.²³³ Second, even an efficient market for stock transactions may be socially objectionable because of distributional concerns, that is, resulting inequities in stock ownership and income.²³⁴

a. *Market imperfections.* The important market imperfections for stock transactions are monopoly power in some parts of the securities industry,²³⁵ inadequate information of investors about market choices,²³⁶ and external costs or benefits not considered by market participants.²³⁷ Professor Coase has argued that inefficiencies due to market imperfections could be corrected by market participants without governmental intervention if bargaining costs²³⁸ among all relevant parties were equal to zero. Assume, for example, inefficiencies caused by a market in which investors have inadequate information about the range of available transactional services. Absent bargaining costs, investors would pool funds to establish an information service to facilitate optimal choices.²³⁹ In other words, investors would reach efficiency through bargaining among themselves, and any regulatory restriction would be unnecessary. Coase's argument, however, is tautological, because it defines efficiency as an economic state that

233. Assumptions regarding individual behavior may also be violated. For example, nonconvexities may occur. See Polinsky, *supra* note 203, at 1675-76.

234. Cf. Kassouf, *Towards a Legal Framework for Efficiency and Equity in the Securities Markets*, 25 HASTINGS L.J. 417, 418 (1974).

235. See generally F. SCHERER, *supra* note 203, at 13-19.

236. See generally Whitford, *The Functions of Disclosure Regulation in Consumer Transactions*, 1973 WIS. L. REV. 400.

237. See generally E. MISHAN, *THE COSTS OF ECONOMIC GROWTH*, chs. 5-6 (1967).

238. Bargaining costs include the costs of gathering information, organizing consumers, and transferring property rights. Coase calls these "transaction" costs, Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). The term "bargaining" costs is used here to avoid confusion.

239. See Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961). Coase himself applies his thesis to externalities. See Coase, *supra* note 238.

must exist in the absence of bargaining costs.²⁴⁰ If there were no bargaining costs, market imperfections would not exist in the first place.

In practice, the cost to parties of finding each other and reaching an agreement may outweigh the gains that could be achieved through private bargaining.²⁴¹ Bargaining costs will be very high if correction of a market failure requires agreement among all American investors, as would be the case if private bargaining alone were relied upon to prevent fraudulent transactions based on inside information.²⁴² Market correction through bargaining may be constrained by conflicts among the interests of various market participants, such as individual and institutional investors.²⁴³ Voluntary correction of market failures may also be stymied by free riders who refuse to pay for protection against an abuse such as specialist manipulation because they will receive the benefits of protection so long as other investors pay.²⁴⁴

Thus, the revised *Silver* test is an appropriate tool for comparing the costs of correcting market imperfections through bargaining or regulation. If bargaining is less expensive than regulation, we should allow the market to correct itself or pass a rule to facilitate the bargaining process, such as a law allowing freer use of class actions.²⁴⁵ In such situations, regulatory restrictions would impose extra administrative costs. On the other hand, if bargaining is very expensive and regulation is not, the efficiency gains of a regulatory restriction may very well outweigh its administrative costs. In such a situation an unregulated market would not reach operational efficiency through bargaining. If we are unsure about the relative costs of

240. See Calabresi, *Transaction Costs, Resource Allocation and Liability Rules*, 11 J. LAW & ECON. 67, 67-73 (1968). While the perfect competition model also can be called tautological, it is explicitly used here as an analytical construct with discrete limits, rather than a comprehensive justification for actual trading patterns.

241. See Heymann, *The Problem of Coordination: Bargaining and Rules*, 86 HARV. L. REV. 797, 817-27 (1973).

242. See R. POSNER, *supra* note 213, at 183-84.

243. Cf. BNA SEC. REG. & L. REP. NO. 282, at A-7 (Dec. 18, 1974) (SEC hearings on beneficial ownership, mergers, and takeovers).

244. Cf. G. CALABRESI, *THE COST OF ACCIDENTS* 137 n.4 (1970). There may also be the problem of a hold-out—a person who will not go along with the bargain and whose agreement is necessary for anything to be done. A good example is the owner of a few shares who will not approve a merger in a corporation that requires unanimity for merger votes. For a discussion of the hold-out problem in another context, see David & Whinston, *The Economics of Urban Renewal*, 26 LAW & CONTEMP. PROB. 105, 111 (1961).

245. For an analysis of the way in which the class action mechanism may facilitate the bargaining process, see Note, *The Cost-Internalization Case for Class Actions*, 21 STAN. L. REV. 383 (1969).

the two correction methods, or if we know that each method is superior in specific respects, then we should choose a combination of bargaining and regulation for transactional services.²⁴⁶

b. *Distributional concerns.* The competitive process begins with the present distribution of income and then reaches the most efficient point for that distribution.²⁴⁷ Some people would prefer to change the present distribution of income, however, and advocate regulatory restrictions on stock transactions that would in effect subsidize needy groups. Economists often object to such restrictions on competition because they cause efficiency loss and administrative expense.²⁴⁸ Instead, economists suggest that the government achieve any desired redistribution by extramarket means (e.g., taxation) and allow the market to reach the most efficient point for this new income distribution.²⁴⁹

In the real world, the best method of redistribution is a more complicated question. The unstated premise of the economists is that extramarket distribution involves lower costs than those imposed by redistribution through restrictions on the market. In fact, extramarket methods may themselves impose substantial costs.²⁵⁰ An income tax, for example, requires a bureaucracy and may decrease the incentive to work.²⁵¹ Because both taxation and regulatory restrictions may entail administrative expense and efficiency loss, the revised *Silver* test is an appropriate tool for comparing the relative costs of these alternative methods of redistributing income.

In discussions about reforms for the stock markets, a plea for the individual investor is often made on distributional grounds.²⁵² Recent proposals call for regulatory restrictions on share ownership²⁵³

246. Professor Calabresi writes: "The resource allocation aim is to approximate, both closely and cheaply, the result the market would bring about if bargaining actually were costless. The question then becomes: Is this accomplished most accurately and most cheaply by structural rules (like anti-trust laws), by liability rules, by taxation and governmental spending, by letting the market have free play or by some combination of these?" Calabresi, *supra* note 240, at 69 (footnotes omitted).

247. See generally Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1096 (1972).

248. For an illustrative discussion of the problems caused by restrictions on the market process to help the poor, see R. POSNER, *supra* note 213, at 259-63.

249. See, e.g., Polinsky, *supra* note 203, at 1668-69.

250. Taxation is the usual method by which income is redistributed outside of the market process. A tax without some distortion of efficient behavior, however, is virtually impossible to achieve. For a survey of the costs associated with different methods of redistribution, see R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 443-64 (1973).

251. Polinsky, *supra* note 203, at 1678.

252. See Rolo, *The Case of the Vanishing Investor*, N.Y. Times, June 9, 1974, § 6 (Magazine), at 14 (June 9, 1974).

253. S. 2842, 93d Cong., 1st Sess. §§ 2-3 (1973).

and trading patterns²⁵⁴ of institutional investors aimed at protecting disadvantaged individual investors. The idea of restricting stock transactions to help individual investors, however, is fundamentally misguided on distributional grounds.²⁵⁵ Individual investors do not represent the poor or moderate-income families in America; individual stock ownership is highly concentrated in families with annual incomes of over 100,000 dollars.²⁵⁶ In contrast, the beneficiaries of pension funds are mainly low or moderate-income families;²⁵⁷ the beneficiaries of mutual funds²⁵⁸ and the holders of insurance stocks²⁵⁹ are middle-income more than wealthy families.²⁶⁰ While restrictions on stock transactions could be designed to increase the share ownership of low and moderate-income families in the future, such restrictions would certainly be more costly than income redistribution through an established tax system. Redistribution through subsidized stock transactions allegedly offers the benefit of broader participation in corporate ownership,²⁶¹ but the importance of this benefit is suspect because small shareholders cannot effectively participate in the management of large corporations.²⁶²

254. See text at notes 443-68 *infra*.

255. To the extent that the plea for the individual investor has any validity, it is an efficiency argument about the adverse impact of institutional investors on liquidity—a problem of market imperfection. See, for example, the critique of institutional impact on market efficiency in Loomis, *How the Terrible Two-Tier Market Came to Wall Street*, FORTUNE, July 1973, at 82. Even this efficiency argument, however, has been seriously questioned in recent studies of stock transactions by institutional investors. See INSTITUTIONAL INVESTOR STUDY, *supra* note 196, pt. III, chs. 10-13; U.S. TREAS. DEPT., PUBLIC POLICY FOR AMERICAN CAPITAL MARKETS 12-15 (1974).

256. These wealthy families own over 80 per cent of the market value of all corporate stock held by noninstitutional investors. INSTITUTIONAL INVESTOR STUDY, *supra* note 196, Supp. I, at 388, 392.

257. U.S. BUREAU OF LABOR STATISTICS, DEPT. OF LABOR, REP. NO. 423, COVERAGE AND VESTING OF FULL-TIME EMPLOYEES UNDER PRIVATE RETIREMENT PLANS: FINDINGS FROM THE APRIL 1972 SURVEY 22 (1973).

258. In 1970, the median income of mutual fund shareholders was \$14,600, and only 30 per cent of all mutual fund shareholders had incomes above \$20,000. DETAILED LOOK, *supra* note 196, at 82.

259. There is sparse data on the income distribution of insurance stockholders. Mutual insurance companies, which control two thirds of all insurance assets, are formally controlled by their policyholders. Because the two most important types of mutual insurance policies are automobile and ordinary life policies, the policyholders tend to represent a broad cross-section of the American population. For example, 57 per cent of all new purchases of ordinary life insurance policies were made by individuals with annual incomes below \$10,000. INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACTBOOK 17 (1974).

260. Although no precise statistics are available, most beneficiaries of bank trusts are probably from a high-income group.

261. In the 1960's, for example, the NYSE used the following slogan in its advertisements: "Own Your Share of American Business." Letter from Daniel H. Woodward, Jr., to the author, January 29, 1975.

262. See Manning, Book Review, 67 YALE L.J. 1477 (1958).

Similarly, the distributional pleas for the small broker are at odds with the empirical data on the stock markets.²⁶³ It is often argued that regulatory restrictions on the market for stock transactions are needed because open competition would lead to the demise of small brokerage firms.²⁶⁴ This argument assumes that small brokers are less efficient than large brokerage houses.²⁶⁵ That assumption, however, has been refuted by several scholars.²⁶⁶ In the definitive study on this subject, Professors Friend and Blume concluded:

The study gives no support to the view that it is the small and regional firms which would be mainly affected by any decline in brokerage profitability, with possibly disastrous consequences for these firms and for sectors of the economy which they service. An analysis of the cost and profit structure of NYSE firms and of changes in the concentration of securities business over time leads to the conclusion that economies of scale in the brokerage business do not seem to be very strong, especially for regional firms.²⁶⁷

Thus, while market imperfections and distributional concerns may justify regulatory restrictions in the stock market, the mere presence of some bargaining and redistribution costs does not require the imposition of regulatory restrictions. Rather, the decision to regulate should only follow a careful evaluation of regulatory benefits, efficiency losses, and administrative expenses of the proposed restriction. Since some of these factors may not be readily quantifiable for particular restrictions, some per se rules for applying this new approach to stock transactions would be helpful.²⁶⁸ In light of the above critique of subsidizing transactions for needy investors or brokers, restrictions with such distributional goals should face a very strong negative presumption under the revised *Silver* test. The

263. See *Senate Report Analyzes Regulatory Paperwork Burden on Small Broker-Dealers, Criticizes SEC Progress*, BNA SEC. REG. & L. REP. NO. 257, at A-15 to -17 (June 19, 1974).

264. For example, the NYSE argues that fixed commission rates are necessary to subsidize small brokers against destructive competition from large brokers. See NYSE, *ECONOMIC EFFECTS OF NEGOTIATED COMMISSION RATES ON THE BROKERAGE INDUSTRY, THE MARKET FOR CORPORATE SECURITIES, AND THE INVESTING PUBLIC* 43-83 (1968).

265. See SENATE STUDY, *supra* note 1, at 52.

266. Dr. Garil has shown that, for the year 1967, 70 NYSE firms had higher profit margins than Merrill Lynch, the largest brokerage firm, and 240 firms had higher profit margins than the average for the largest 10 brokerage firms. The NYSE's own analysis of its member firms in 1971 found that the average profit for all firms was 6.2 per cent, as compared to 5.3 per cent for the 34 largest member firms. SENATE STUDY, *supra* note 1, at 52-53.

267. I. FRIEND & M. BLUME, *supra* note 184, at 395.

268. Cf. Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 HARV. L. REV. 226, 278-355 (1960).

balance under the suggested approach is not so clear for restrictions on stock transactions designed to correct market imperfections. Because the data required to evaluate such restrictions may be subject to varying interpretations, the procedures for applying the revised *Silver* test must provide for competing fact-finders.²⁶⁹

B. *Procedures for the Revised Silver Test*

Implementation of the revised *Silver* test requires a new set of procedures less dependent on the courts. Without assistance from Congress, the SEC, and the Antitrust Division, many judges may be unable to carry out the economic analysis of empirical data demanded by the revised *Silver* test. Nor does the traditional separation between antitrust suits against SRO's and judicial review of SEC decisions make sense when one substantive test is used to evaluate all regulatory restrictions on stock markets. A single forum should be designated to review cases in light of input from the Congress, the SEC, and the Antitrust Division.

1. *Congress*

Congress has three main functions under the revised *Silver* test. First, it should pass legislation that defines the new substantive test and details procedures to be followed in assessing restrictions on transactional services. Under present law, a court could reach the revised *Silver* test by considering competitive factors under a public policy rubric on direct review of a regulatory restriction,²⁷⁰ or by taking a regulatory approach in applying the "necessity" test in an original antitrust suit.²⁷¹ Similarly, courts might now create a single procedure for judicial review through liberal joinder of administrative and antitrust claims²⁷² and by permitting intervention by the Justice Department and the SEC in each other's cases.²⁷³ An explicit congressional mandate for the new substantive test, however, would provide a stronger legal foundation. The recent Senate bill moves in this direction by defining its "necessary or appropriate" standard in terms of the regulatory costs and benefits of any restriction.²⁷⁴ Its

269. See text at notes 282-323 *infra*.

270. Cf. *Gulf State Util. Co. v. FPC*, 411 U.S. 747, 756-62 (1973); *Denver & Rio Grande W. R.R. v. United States*, 387 U.S. 485 (1967).

271. Cf. Pitosky, *Joint Ventures Under the Antitrust Laws: Some Reflections on the Significance of Penn-Olin*, 82 HARV. L. REV. 1007, 1057-58 (1969).

272. See FED. R. CIV. P. 18, 20, 42.

273. See, e.g., *Thill Sec. Corp. v. NYSE*, 469 F.2d 14, 15 (7th Cir. 1972) (intervention by SEC and Antitrust Division); Justice Department Brief, *supra* note 112.

274. See text at notes 170-72 *supra*.

provision for SEC and judicial review of almost all SRO decisions incorporates significant elements of the new procedure outlined below.²⁷⁵

Congress might also involve itself more directly in assessing the effects of regulation. For example, it might set up new investigatory teams on certain aspects of transactional services or direct the SEC to conduct such a study.²⁷⁶ Congress could demand more extensive annual reports from the SEC about the costs of regulation.²⁷⁷ Congressional committees could focus more clearly on the three variables weighed under the revised *Silver* test—regulatory benefits, efficiency losses, and administrative expenses—in hearings held to gather facts about stock market proposals.²⁷⁸

Finally, when enacting legislation that affects stock markets, Congress should provide the SEC with definite directions about restrictions on stock transactions. Congress could set up detailed regulatory schemes similar to the insurance system for broker-dealers passed in 1970.²⁷⁹ To ensure periodic review, Congress could follow the legislative model of section 167k of the Internal Revenue Code, which terminates at a specific date unless extended. Even if Congress gives the SEC open-ended authorization to implement reforms on a subject, it should articulate its desired regulatory goals in more precise terms than "investor protection" and "orderly markets."²⁸⁰ A detailed congressional mandate would be favored by the courts under the procedures suggested below.²⁸¹

275. See text at notes 154-62 *supra*. But see text at notes 163-65 *supra*.

In addition to the recent Senate bill, Congress would have to pass provisions with respect to the Antitrust Division's right to challenge SEC conclusions, see text at notes 290-96 *infra*; the increased weight of the Division's findings in judicial review of SEC decisions, see text preceding note 302 *infra*; the elimination of antitrust claims against SRO's, see text at notes 297-301 *infra*; and the award of attorney's fees for successful appeals of SEC decisions. See text at note 318 *infra*.

276. Congress recently directed the SEC to undertake a study of institutional investors. See INSTITUTIONAL INVESTOR STUDY, *supra* note 196, at v. Cf. S. Res. 109, 92d Cong., 1st Sess. § 2 (1971), authorizing the Senate Committee on Banking, Housing and Urban Affairs "to examine, investigate, and make a complete study of any and all matters pertaining to the securities industry and the securities markets of the United States."

277. See, e.g., S. 249, 94th Cong., 1st Sess. § 17 (1975) (requiring cost-breakdowns on self-regulation). This section also requires the SEC to include in its annual reports information on the development of a national market system and the steps taken toward equal regulation of market participants.

278. See, e.g., *Securities Industry Study*, *supra* note 191.

279. Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-III (1970).

280. Cf. Securities Exchange Act of 1934, § 11(a), 15 U.S.C. § 78k(a) (1970).

281. See text at notes 309-11 *infra*.

2. Administrative Agencies

Even if Congress provides more direction on regulatory policy for the stock market, the SEC will still have to implement congressional mandates by issuing rules, and it should have the power to review all SRO restrictions.²⁸² Before issuing its own rules or passing on SRO restrictions, however, the SEC should examine the regulatory benefits of its recommendations relative to their efficiency costs and administrative expenses.²⁸³ To conduct this analysis, the SEC could expand its currently small staff of in-house researchers with economic expertise;²⁸⁴ establish advisory committees, representing a broader cross-section of interests, to make recommendations on specific problems;²⁸⁵ and establish more pilot programs to gather

282. Cf. text at notes 154-58 *supra*.

283. The SEC would also be empowered to review all adjudications by an SRO, cf. text at note 156 *supra*, subject to review by a court of appeals. Cf. text at note 161 *supra*.

Review of an adjudication by the SEC could be sought on various grounds. If invalidity of an SRO rule under the new substantive test were asserted, the SEC would follow the procedures outlined below. See text at notes 320-23 *infra*. If, however, the appellant claims only that an otherwise valid restriction has been misapplied, the SEC would not have to undertake a thorough reevaluation of economic impact and regulatory benefit. Under the recent Senate bill, the SEC could affirm the SRO's decision, modify it, or remand for further proceedings, as well as cancel, reduce, or require the remission of any penalty. S. 249, 94th Cong., 1st Sess. § 15 (1975). While these remedies appear adequate for most cases, in some instances an aggrieved party may suffer monetary damage because of an SRO's misapplication of its rules. The SEC therefore should have the power to award money damages to the aggrieved party. Cf. National Labor Relations Act § 10(c), 29 U.S.C. § 160(c) (1970). This would not violate the SRO's seventh amendment right to a jury trial; the Supreme Court has cited administrative expertise as justifying an exception to the right in agency proceedings. *Curtis v. Loether*, 415 U.S. 189, 194-95 (1973). In addition, the aggrieved party might be able to sue the SRO for money damages under a statutory tort theory. See *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), cert. denied, 323 U.S. 737 (1944); Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633 (1966); Note, 73 COLUM. L. REV. 1262, *supra* note 55.

284. The SEC now has one chief economist with a small staff. SEC lawyers, not unlike other lawyers, are largely untrained in economics. Cf. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 623 (1969).

285. The SEC has been working with a number of advisory committees on various aspects of the central market plan (see text at note 18 *supra*), but the committees suffer from several defects. The SEC is relying on a Securities Industry Association (SIA) committee for advice concerning a central clearing facility. The SIA is the trade organization of broker-dealers and does not hold publicly announced meetings. Interview with Anthony Nuland, Special Counsel, SEC Office of Broker-Dealer Financial Responsibility and Securities Transactions, Washington, D.C., April 12, 1974. Similarly, the original advisory committee on the central market met in private and was composed of nine representatives from the securities industry and two SEC staff members. SEC ADVISORY COMM. REPORT ON THE IMPLEMENTATION OF A CENTRAL MARKET SYSTEM (1974), reprinted in CCH FED. SEC. L. REP. No. 469 (March 9, 1973). Recently, the SEC appointed a second advisory committee under the Federal Advisory Committee Act, 5 U.S.C. app. I, §§ 1-15 (Supp. II, 1972). This Act requires public meetings and public records. Although the new committee has five representatives from outside the broker-

empirical data on regulatory proposals.²⁸⁶ The Commission should also hold hearings on all major regulatory decisions, not only to acquire relevant information but also to give affected market participants and the Justice Department an opportunity to present their views.²⁸⁷ Counsel should be permitted for all participants in the hearing, and relevant SEC information should be available on request.²⁸⁸ After the hearing, the SEC would report its findings on each of the three factors considered under the revised *Silver* test and issue a reasoned opinion setting forth its conclusion as to whether regulatory benefits outweigh potential costs and losses.²⁸⁹

The procedures outlined above should provide some check upon the regulatory predisposition of the SEC. Increased participation by the Antitrust Division of the Justice Department may be expected to emphasize competitive values. The Division historically has been a strong critic of regulatory policies condoned by the SEC,²⁹⁰ and has vast experience in dealing with the economic impact of governmental restrictions.²⁹¹ Under the new procedure, it would have the power to challenge the SEC's conclusions about restrictions on stock transactions.²⁹² Such an option would permit the Division to restrain

dealer community, it has no representatives of small investors, and seven representatives, including the chairman, come from the securities industry. See the bibliography of members in SEC, Advisory Committee on the Implementation of a Central Market System—First Meeting Discussion Topics (May 31, 1974).

286. The SEC has held pilot runs for negotiated rates. See SEC Securities Exchange Act Release No. 11019 (Sept. 19, 1974), BNA SEC. REG. & L. REP. No. 270, at D-1 (Sept. 25, 1974).

287. The SEC has held many public hearings on proposed rules. See, e.g., *id.* at n.7 (intramember rates). However, it has been criticized for not permitting full public participation in dealing with SRO rules. See SENATE STUDY, *supra* note 1, at 196-201. Cf. S. 249, 94th Cong., 1st Sess. § 17 (1975).

288. The SEC has not always permitted public inspection of documents relevant to regulatory decisions. See Note, *supra* note 51, at 822-23. Public inspection would be explicitly permitted when the SEC makes rules or regulations under S. 249, 94th Cong., 1st Sess. § 17 (1975).

289. A good model to follow would be the SEC's explanation of its position on the institutional membership rule. See SEC Securities Exchange Act Release No. 9950, *supra* note 51. Such a reasoned defense of regulatory decisions is explicitly required for SEC rules or regulations by S. 249, 94th Cong., 1st Sess. §§ 15, 17 (1975).

290. For example, the Justice Department initiated the challenge to fixed commission rates. See R. WEST & S. TINIC, *supra* note 178, at 202.

291. For a description of the enforcement policies of the Antitrust Division, see A. NEALE, *supra* note 145, ch. XIII. But compare the criticism of the Division's alleged lax enforcement in M. GREEN, B. MOORE & B. WASSERSTEIN, THE CLOSED ENTERPRISE SYSTEM 30-144 (1972).

292. For an analogous approach, see the role of the Environmental Protection Agency in publishing environmental critiques under the Clean Air Act § 309, 42 U.S.C. § 1857h-7 (1970), and that of the Council on Environmental Quality under the National Environmental Policy Act of 1969, § 204, 42 U.S.C. § 4344 (1970). See generally Leven-

SEC decisions with serious anticompetitive effects, without subjecting the Commission to attacks on inconsequential measures.

The procedures available to the Antitrust Division would be as follows: If the Division objects to the anticompetitive effects of a proposed regulatory restriction, it would have sixty days in which to file critical comments with the SEC. If the SEC either fails to respond or alters its proposed regulation in a manner unsatisfactory to the Division, the latter could solicit written comments and, at the request of a party aggrieved by the proposal, hold its own hearing on efficiency losses. The Antitrust Division would ultimately publish its findings on efficiency losses and its overall conclusion as to the validity of the restriction under the revised *Silver* test. Like the SEC, the Division would give a reasoned defense of its position and provide public access to relevant documents. At each step the Division's action should conform to its own published guidelines for competition in the securities industry.²⁹³

An adverse conclusion by the Antitrust Division could stimulate negotiations between the Division and the SEC on revising the proposed regulation.²⁹⁴ In these negotiations the SEC would be under pressure from several sources to accommodate the view of the Antitrust Division. The Division's notices in the Federal Register might attract the critical attention of legislators as well as the news media. The Division's negative findings on efficiency losses would form part of the record subsequently reviewed by a court of appeals under the procedure described below.²⁹⁵ Moreover, the SEC may sometimes use the Division's opposition for leverage in negotiations with anticompetitive groups from the securities industry.²⁹⁶

thal, *Environmental Decisionmaking and the Role of the Courts*, 122 U. PA. L. REV. 509, 511-18 (1974).

293. The Justice Department should formulate guidelines for intervention into SEC regulatory decisions, similar to those it has issued for challenges to mergers. See Department of Justice Merger Guidelines, 1 CCH TRADE REG. REP. ¶ 4510 at 6,881 (1974). Cf. Posner, *A Program for the Antitrust Division*, 38 U. CHI. L. REV. 500, 529-31 (1971). Published guidelines would give notice to the SEC and the SRO's of what the Division considers anticompetitive activity in the securities industry. They would also provide a constraint upon the exercise of the Antitrust Division's statutory option to sue. To guard against neglect or abuse of the option to sue, private parties should be given the right to seek an injunction requiring the Antitrust Division to follow its guidelines.

294. Cf., e.g., *Harlem Valley Transp. Assn. v. Stafford*, 500 F.2d 328, 331-32 (2d Cir. 1974).

295. See text preceding note 302 *infra*.

296. For instance, the opposition of the Justice Department to fixed commission rates provided the SEC with some leverage in its later attempts to introduce negotiated rates. See Note, 55 VA. L. REV. 661, *supra* note 28, at 667.

3. Courts

Persons who have unsuccessfully challenged a proposed regulatory restriction in the SEC's validation proceedings would have a right to appeal the Commission's decision to a court of appeals within sixty days after expiration of the period during which the Antitrust Division might act, or, if the Division does act, within sixty days after the Division publishes its findings.²⁹⁷ While similar disputes may now be heard either in an original antitrust suit against an SRO or pursuant to judicial review of an SEC decision,²⁹⁸ the proposed reform would limit review to a single judicial appeal: Disputes involving SRO actions reviewed by the SEC would be litigated only on review of SEC decisions in the courts of appeals, and antitrust suits against SRO's would be eliminated. The proposal is designed to emphasize the respective advantages of both existing procedures. Agencies are better equipped than antitrust courts to gather the empirical data required under the revised *Silver* test.²⁹⁹ The SEC's increasing involvement in the regulatory actions of SRO's³⁰⁰ and the development of a central market system,³⁰¹ in particular, make the Commission a more competent forum in which to build a record for further review than a district court. This is not to suggest, however, that judicial review of SEC decisions should be a narrow inquiry into abuses of SEC discretion. Rather, the court should make a relatively independent assessment of a challenged restriction with the aid of competing fact-finders, and should provide appropriate relief *before* monetary claims arise from anticompetitive regulations.

In reviewing the SEC's conclusions on a regulatory restriction under the revised *Silver* test, the court should use the substantial evidence rule to assess only the SEC's findings on regulatory benefits and administrative expense: It should obtain data on efficiency losses from other sources. If the Antitrust Division has made findings on efficiency losses, the court should apply the substantial evidence test to them. If the Antitrust Division has not exercised its option, the court should review *de novo* the SEC's findings on efficiency losses and permit the parties to present affidavits on this factor. By utilizing competing fact-finders,³⁰² the new procedure permits the

297. The Antitrust Division might also be empowered to appeal SEC decisions.

298. See text at notes 37-39 *supra*.

299. See Note, *The Back Office Problem and the Antitrust Laws*, 69 COLUM. L. REV. 299, 307 (1969); Note, 1970 U. ILL. L.F. 544, *supra* note 28, at 566-67.

300. For the judicial trend, see text at notes 42-55 *supra*; for the legislative trend, see text at notes 154-62 *supra*.

301. See text at note 18 *supra*.

302. One of the drawbacks in the analogous area of environmental law is the prac-

court some independence from any one agency's special expertise and bias, and simultaneously avoids a rehearing of all of the evidence.³⁰³

The court would independently balance the agency findings under the revised *Silver* test to determine whether regulatory benefits in fact outweigh efficiency losses and administrative costs.³⁰⁴ The result under this balancing test will sometimes be clear-cut. For instance, a restriction may give rise to substantial regulatory benefits with negligible efficiency losses,³⁰⁵ or it may not implement any regulatory goals.³⁰⁶ However, the courts will face difficult cases in which the economic analysis of the revised *Silver* test will not yield a clear-cut answer. In such cases, the court could appoint an economics expert as a master to assist in the decision,³⁰⁷ ask an agency to obtain more information about the impact of a regulation, or tentatively approve a new regulation while retaining jurisdiction in anticipation of subsequent developments.³⁰⁸

If resolution on the economic merits of the dispute remains unclear, courts should consider the following guidelines for disposing of the case. First, courts should look for direction from Congress. Congress sometimes passes detailed regulations for stock transactions.³⁰⁹ When such legislative mandates are incorporated into SEC or SRO restrictions, courts should defer to the implicit congressional judgment that the benefits of the regulation outweigh its administrative and efficiency costs. No such deference is due SEC or SRO regulations that are based only upon some vague legislative mandate

tical difficulty of reviewing cost-benefit analyses offered by only one agency. Instead of undertaking an independent examination of the data, some courts have refused to review the agency determinations. See Leventhal, *supra* note 292, at 527-29.

303. The Permian Basin Area Rate Cases, 390 U.S. 747 (1968), exemplify the Supreme Court's reluctance to immerse itself in the technical minutiae of a heavily regulated industry. While some older cases required de novo review of agency decisions in certain areas, these precedents are waning quickly. DAVIS TEXT, *supra* note 152, at 539-42. The court has gravitated more and more to the substantial evidence rule. *Id.* at 526.

304. Courts are now undertaking review of cost-benefit analyses in the environmental area. See, e.g., Calvert Cliffs' Coordinating Comm. v. AEC, 449 F.2d 1109, 1123, 1128 (D.C. Cir. 1971). For a defense of the feasibility of a balancing test on the similar issue of state regulation and the antitrust law, see Slater, *supra* note 106, at 104-08.

305. Cf. text at notes 131-32 *supra*.

306. If regulatory gains and efficiency losses are both zero, the restriction would be invalid because all restrictions impose some administrative expense.

307. See, e.g., First Iowa Hydro Elec. Coop. v. Iowa-Illinois Gas & Elec. Coop., 245 F.2d 613, 627-28 (8th Cir.), cert. denied, 355 U.S. 871 (1957). See generally Kaufman, *Masters in the Federal Courts: Rule 53*, 58 COLUM. L. REV. 452, 455-59 (1958).

308. Cf. Otter Tail Power Co. v. United States, 410 U.S. 366, 381 (1973).

309. See, e.g., Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-III (1970).

such as promoting investor protection or stabilizing the stock market.³¹⁰ Indeed, courts should discount the benefits of these regulations; such vague policies could be employed to rationalize almost any anticompetitive intrusion into the market for stock transactions. Intermediate situations, in which regulations are authorized by Congress on certain discrete subjects without delineation of their content,³¹¹ should carry no presumption, so courts must use other guidelines.

Second, the courts should favor regulations aimed at facilitating the bargaining process in the private market and disfavor those involving a high degree of government intervention into the securities business, because efficiency losses from the former are generally easier to correct.³¹² For example, compare a regulation making brokers liable for damages incurred by nondisclosure of certain information with a flat requirement that this information be given to all investors. Assume that certain information covered by both regulations ultimately proves worthless to investors. While the liability regulation provides a mechanism by which to correct resource misallocations, the disclosure requirement does not.

Similarly, courts should favor restrictions that may readily be corrected through the political process if proved unwise.³¹³ Assume, for example, that the enforcement costs for margin requirements could be financed either through a user tax on investors with margin accounts or an SEC appropriation taken from general tax revenues. If enforcement costs ultimately exceed regulatory benefits, investors with margin accounts are more likely to bring political pressure for a new regulation than are taxpayers in general.

In doubtful cases courts should also view critically a regulation whose goals can as well be achieved by existing legal mechanisms,³¹⁴ such as private suits, SEC actions under existing regulations aimed at specific abuses,³¹⁵ or more general rules, such as rule 10b-5.³¹⁶ Con-

310. See, e.g., SENATE STUDY, *supra* note 1, at 161-63 (rules adopted by two exchanges concerning sales of life insurance by member firms).

311. See, e.g., Securities Exchange Act of 1934, § 11(a), 15 U.S.C. § 78k(a) (1970).

312. See G. CALABRESI, *supra* note 244, at 150-52.

313. See generally *id.* at 144-50.

314. See R. POSNER, *supra* note 213, at 156.

315. See, e.g., rule 15c1-7, 17 C.F.R. § 240.15c1-7 (1974). See generally Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).

316. 17 C.F.R. § 240.10b-5 (1974). See Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869 (1972).

The SEC is empowered to investigate abuses in securities markets. Securities Exchange Act of 1934, § 21, 15 U.S.C. § 78u (1970). Injunctive actions by the SEC may serve as the basis for private damage actions. See, e.g., *Cannon v. Texas Gulf Sulphur*

versely, if the current remedies for a particular abuse are inadequate,³¹⁷ courts should be more favorably disposed toward new regulation aimed at the abuse.

If the results of the balancing test are favorable—that is, if regulatory benefit outweighs efficiency loss and administrative costs—the court would validate the regulation. If the results are unfavorable, the court would invalidate the regulation, enjoin its future enforcement, and award the plaintiff attorney's fees to be paid by the issuer of the regulation.³¹⁸ Invalidation and award of fees should provide sufficient incentive for challenging regulatory restrictions to investors, brokers, exchanges, and other parties who may be injured by the implementation of anticompetitive regulations. The court, however, would generally not be permitted to entertain damage claims against SRO's for past injuries caused by an invalidated regulation.³¹⁹ After Congress enacts the new review procedures, a regulation alleged by the Justice Department or an aggrieved party to have anticompetitive effects on stock transactions will not become effective unless it meets the revised *Silver* test according to the combined judgment of the SEC, the Antitrust Division, and the courts.

Four main problems are raised by the elimination of damage claims against SRO's for invalid restrictions, all of which can be resolved by appropriate provisions in new legislation. First, some plaintiffs may have filed antitrust suits against SRO's before the enactment of the new procedures for deciding cases under the revised *Silver* test. The new legislation should not be retroactive; any prior claim for monetary damages would be decided under prior law.³²⁰ Second, some existing regulations not previously scrutinized under the revised *Silver* test may have serious anticompetitive effects on stock transactions.³²¹ The new legislation should therefore require the SEC to review all current restrictions on stock transactions³²²

Co., 309 F. Supp. 548 (D. Utah 1970) (private suits based upon SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971)).

317. Private investor suits may be inadequate in certain areas because investors are unable to detect abuses or because individually they have insufficient financial interests to justify litigation. They may also face defendants with funds inadequate to pay judgments. *But cf.* Securities Investor Protection Act of 1970, §§ 5-6, 15 U.S.C. §§ 78ee-fff (1970) (protection against brokers as bankrupt defendants).

318. *Cf.*, e.g., Clayton Act § 4, 15 U.S.C. § 15 (1970); Communications Act of 1934, § 206, 47 U.S.C. 206 (1970).

319. *But see* note 283 *supra* (money damages for misapplication of a previously approved regulation).

320. *See generally* text at notes 37-152 *supra*.

321. *See* SENATE STUDY, *supra* note 1, at 104-05.

322. *Cf.* S. 249, 94th Cong., 1st Sess. § 26 (1975).

within one year and invoke the new procedures for any regulation at the request of the Justice Department or an aggrieved person. Third, years after a regulation has been validated it may impose new anticompetitive effects because of changes in the structure of the securities industry. The new legislation should require the SEC to review all restrictions at reasonable intervals (*e.g.*, every seven years) and to hold hearings on a regulation at the request of the Justice Department or an aggrieved party. Fourth, between these periodic reviews a validated regulation may impose anticompetitive effects with respect to a party who was not eligible to participate in previous validation proceedings.³²³ The new legislation should permit the party to contest the regulation under the revised *Silver* test by making a *prima facie* showing of important evidence that was not considered by the SEC at the last validation proceeding.

In sum, the revised *Silver* test envisions input from all three branches of government in dealing with regulatory restrictions on stock transactions. Congress should provide empirical data on the stock markets and articulate a set of regulatory goals. The SEC should assess the regulatory and competitive impact of all restrictions, although the Justice Department should have the option to issue independent findings on competitive impact. After deferring to the SEC findings on administrative costs and regulatory benefits and to the Justice Department findings on efficiency losses, the courts should weigh three factors according to the revised *Silver* test. Because the courts will favor regulations based on detailed legislative enactments and supported by the Justice Department, Congress should have increased incentive to articulate more precise mandates for the SEC, and the SEC should give more weight to the critiques of the Antitrust Division. Ultimately, such disputes should be settled without frequent resort to the judiciary.

III. APPLICATION OF THE ALTERNATIVE APPROACH TO SELECTED REGULATORY DECISIONS

To illustrate the utility of the revised *Silver* test, this section will compare the results of its application to certain regulatory decisions with those obtained under the present approach. Current reforms in the securities industry provide concrete examples for comparison. While the NYSE and other exchanges have heretofore maintained minimum commission rates that member firms may charge public

323. For example, a person might not have owned any stock at the time of the last validation proceeding. See also note 283 *supra*.

investors,³²⁴ the SEC has announced the institution of negotiated rates as of May 1, 1975.³²⁵ The absence of a common communications system³²⁶ and the existence of regulatory barriers³²⁷ have inhibited comparative shopping by brokers among marketplaces, but the SEC has issued policy statements favoring a central market connecting all brokers.³²⁸ In the context of these recent developments, this section will analyze: (1) an antitrust suit before the Supreme Court challenging fixed commission rates; (2) congressional and SEC proposals for the transition from negotiated rates to the central market; and (3) the SEC's plan for a central tape as the first part of the central communications system.

A. Fixed Commission Rates and the Gordon Case

By granting certiorari in *Gordon v. NYSE*,³²⁹ the Supreme Court has decided to examine the proper forum for an antitrust suit against a stock exchange for the first time since *Silver* was decided.³³⁰ The plaintiff in *Gordon* sued the NYSE and AMEX³³¹ for fixing commission rates in violation of the antitrust laws.³³² The district court granted summary judgment for the defendants, holding that it could not hear the antitrust claim because section 19(b)(9) of the 1934 Act

324. For a history of fixed commission rates, see R. DOEDE, *THE MONOPOLY POWER OF THE NEW YORK STOCK EXCHANGE* (June 1967), reprinted in *Hearings on S. 3169*, *supra* note 184, at 405, 409-27.

325. SEC Securities Exchange Act Release No. 11203, *supra* note 16.

326. Historically, the tape, quote, and clearing systems that did exist were attached exclusively to one marketplace, although lately there has been some cooperation between marketplaces, as with the joint clearing corporation of the NYSE and AMEX. See *HOUSE STUDY*, *supra* note 7, at 59-63; *SENATE STUDY*, *supra* note 1, at 96-104. For this reason, a broker could not compare price information on stocks offered simultaneously in different marketplaces, and could clear only at marketplaces of which the broker was a member.

327. See *HOUSE STUDY*, *supra* note 7, at 126-28; *SENATE STUDY*, *supra* note 1, at 104-05.

328. The central communications plan includes tape, quote, and clearing systems that would connect all existing marketplaces. See SEC Policy Statement, *supra* note 18, at 11-16.

329. 498 F.2d 1303 (2d Cir.), *cert. granted*, 43 U.S.L.W. 3290 (U.S. Nov. 19, 1974) (No. 74-304).

330. See text at notes 30-36 *supra*. *Ricci v. Chicago Mercantile Exch.*, 409 U.S. 289 (1973), was an antitrust claim against a commodities exchange. See note 42 and text at notes 42-46 *supra*.

331. The complaint also accused two representative member firms of the exchanges—Merrill Lynch, Pierce, Fenner & Smith and Bache & Co., Inc. 498 F.2d at 1304 n.1.

332. The claim was based on the Sherman Act, 15 U.S.C. §§ 1, 2 (1970), as well as the Robinson-Patman Act, 15 U.S.C. § 13(2) (1970). The court stated that there was no precedent for treating brokerage services as "commodities" for the purpose of the Robinson-Patman Act, and held that only the Sherman Act claim was cognizable. 498 F.2d at 1305 n.7.

gave the SEC exclusive jurisdiction over commission rates.³³³ In an opinion by Chief Judge Kaufman, the Second Circuit affirmed and suggested that an appeal from SEC action was the proper route for judicial review of commission rates.³³⁴ The court justified this choice of forum on four grounds: the Supreme Court's opinion in *Silver*, the legislative history of the 1934 Act, the statutory language of that Act, and policy arguments favoring administrative hearings. None of these reasons, however, properly disposes of *Gordon*. So long as the case is couched as a jurisdictional choice between an administrative agency and an antitrust court,³³⁵ the Supreme Court cannot base its decision on firm legal grounds or clear policy reasons.

1. *The Second Circuit's Approach to Gordon*

In *Gordon*, Chief Judge Kaufman said: "Any analysis of the interrelation of the antitrust laws and the system of supervised exchange self-regulation embodied in the 1934 Act must begin with *Silver v. New York Stock Exchange* . . ."³³⁶ According to Kaufman, the Court decided *Silver* in favor of antitrust court jurisdiction because the absence of SEC jurisdiction over the relevant regulation precluded judicial conflict with the agency, and denial of antitrust court jurisdiction would have left no governmental body to prevent unjustifiable injury to competition.³³⁷ Since the SEC can review commission rates under section 19(b)(9), however, the court concluded that "the *Silver* rationale might well authorize us to ground our holding here on the existence of SEC review power . . ."³³⁸ But, as the Chief Judge recognized, the Court in *Silver* explicitly reserved decision on cases in which the SEC has jurisdiction to review a challenged rule.³³⁹ Other courts have read *Silver* to imply the existence of antitrust court jurisdiction in cases subject to SEC oversight.³⁴⁰ If the meaning of the *Silver* opinion for antitrust claims

333. 366 F. Supp. 1261, 1264 (S.D.N.Y. 1973).

334. 498 F.2d at 1311. Chief Judge Kaufman noted that an appeal could be taken under Securities Exchange Act of 1934, § 25, 15 U.S.C. § 78y (1970), or Administrative Procedure Act §§ 10(a), (c), 5 U.S.C. §§ 702, 704 (1970). 498 F.2d at 1311.

335. See text at notes 37-39 *supra*.

336. 498 F.2d at 1305.

337. 498 F.2d at 1305.

338. 498 F.2d at 1305.

339. 498 F.2d at 1305. See note 41 *supra* and accompanying text.

340. See, e.g., *Thill Sec. Corp. v. NYSE*, 433 F.2d 264 (7th Cir. 1970), *cert. denied*, 401 U.S. 994 (1971). See also *Harwell v. Growth Programs, Inc.*, 451 F.2d 240 (5th Cir. 1971), *cert. denied*, 409 U.S. 876 (1972), discussed in note 83 *supra*; *Frederickson v. Merrill Lynch, Pierce, Fenner & Smith*, BNA SEC. REG. & L. REP. No. 271, at D-1 (Oct. 2, 1972).

subject to SEC review were as clear as the Second Circuit suggested, there might not have been a split in the lower courts on such claims³⁴¹ and the Supreme Court might not have granted certiorari in *Gordon*.³⁴²

Chief Judge Kaufman next asserted that "[e]xemption from the antitrust laws with regard to the fixing of minimum rates of commission is . . . mandated by both the language and the legislative history of the 1934 Act, and in particular § 19(b)(9)" ³⁴³ He interpreted the legislative history of section 19(b)(9) in light of congressional awareness that price-fixing had been declared a per se violation of the antitrust laws,³⁴⁴ that minimum commission rates had existed in the securities industry,³⁴⁵ and that, according to Samuel Untermyer, section 19(b)(9) "would permit the Commission to fix rates."³⁴⁶ Even the district court in *Gordon* concluded, however, "that the legislative history of the 1934 Act is, perhaps typically, ambiguous as to Congress' intent regarding the Exchanges' long-standing practice of fixing commission rates."³⁴⁷ Moreover, the Justice Department has marshaled historical evidence to show that the 1934 Act was not intended to mandate fixed commission rates,³⁴⁸ including testimony by Untermyer interpreting section 19(b)(9) as a protection for investors against excessive commissions.³⁴⁹

From the statutory language of the 1934 Act, the Second Circuit formulated a two-step argument against antitrust court jurisdiction in *Gordon*. First, section 19(b)(9) indicates that reasonable fixed rates are essential to achieve the goals of the 1934 Act.³⁵⁰ Second, section

341. See text at notes 72-83 *supra*.

342. U.S. SUP. CR. R. 19(1)(b) states as a possible circumstance in which certiorari will be granted: "Where a court of appeals has rendered a decision in conflict with the decision of another court of appeals on the same matter"

343. 498 F.2d at 1307, citing *United States v. Trenton Potteries Co.*, 273 U.S. 392 (1927).

344. 498 F.2d at 1307.

345. 498 F.2d at 1307.

346. 498 F.2d at 1307, citing *Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess., pt. 16, at 7705 (1934).

Samuel Untermyer was counsel for a concurrent congressional investigation of the stock markets (the Pujo Committee). Comments of the Justice Department on the Proposal To Adopt Securities Exchange Act Rules 19b-3 and 10b-22, SEC File No. 4-176, at 9 (Dec. 10, 1974) [hereinafter Justice Comments].

347. 366 F. Supp. at 1266. Professor Baxter has written: "[T]he attention of Congress in 1934 was focused on problems of dishonesty, manipulation, and solvency, and . . . no coherent congressional purpose was articulated concerning the problems of intra-industry competitive structure." Baxter, *supra* note 16, at 685.

348. See Justice Comments, *supra* note 346, at 5-11.

349. *Id.* at 9 n.16.

350. 498 F.2d at 1306.

19(b) gives the SEC authority to determine whether changes in the fixed rates at any exchange are "necessary" to the goals of the Act.³⁵¹ This statutory argument would support the conclusion that the SEC should have the first chance to deal with claims against commission rates on exchanges; indeed, *Ricci* might require such a conclusion given subsection 19(b)(9).³⁵² But Chief Judge Kaufman went much further: "As our earlier discussion of the language and history of the 1934 Act indicates, we are of the view that Congress intended to exempt commission rate-fixing from the operation of the antitrust laws, and consequently deprived the courts of even 'secondary' jurisdiction"³⁵³ If this language means that a court cannot entertain an antitrust claim on which the SEC has explicitly refused to act, Chief Judge Kaufman is wrong. The Supreme Court in *Ricci* indicated that the antitrust court should adjudicate the claim in such a case.³⁵⁴ If Kaufman's language means that an antitrust court cannot entertain a claim on which the SEC has taken some action, his position is hardly compelled by congressional intent as inferred from statutory language. One could reasonably infer an opposite congressional intent from the omission of an explicit antitrust exemption for exchanges in the 1934 Act,³⁵⁵ especially in light of the explicit exemption for the NASD in the Maloney Act of 1938.³⁵⁶

The inconclusiveness of the judicial precedents, legislative history, and statutory language requires investigation of policy reasons for the choice of forum.³⁵⁷ Chief Judge Kaufman presented strong arguments for deference to the SEC in *Gordon*. Since 1968, the SEC has been actively reviewing the commission rates established by the stock exchanges.³⁵⁸ If the antitrust courts entertain the *Gordon* claim, conflict might arise between the SEC and the courts.³⁵⁹ Moreover, the Commission's expertise better suits it to decide such a

351. 498 F.2d at 1306.

352. See text at notes 42-55 *supra*.

353. 498 F.2d at 1309-10 n.8.

354. See note 70 *supra* and accompanying text. Otherwise, there would be no body to guard against antitrust infringements. See text at note 337 *supra*.

355. See, e.g., *Frederickson v. Merrill Lynch, Pierce, Fenner & Smith*, BNA SEC. REG. & L. REP. No. 271, at D-1, D-2 to -3 (Oct. 2, 1972), citing cases in which the Supreme Court has disfavored implied exceptions to the antitrust laws.

356. Securities Exchange Act of 1934, § 15A(n), 15 U.S.C. § 78a-3(n) (1970). See note 83 *supra*. For discussion of the opposing inferences that may be drawn from comparisons between the original language of the 1934 Act and the Maloney Act (now section 15A of the 1934 Act), see Comment, *supra* note 28, at 291 n.138.

357. Cf. text at notes 84-100 *supra*.

358. 498 F.2d at 1308-09.

359. 498 F.2d at 1307-08.

fundamental issue as rate structure.³⁶⁰ In particular, the SEC is better able than the courts to supervise the gradual introduction of negotiated rates needed to protect investors against the precipitous collapse of inefficient brokerage firms.³⁶¹ Kaufman's opinion, however, omits arguments that favor antitrust jurisdiction. Although the SEC has expertise in the area of market regulation, the antitrust courts have expertise on matters of competition.³⁶² Generally the SEC has a bureaucratic bent toward regulation rather than competition, which cannot be checked effectively by judicial review.³⁶³ Moreover, brokers have already absorbed much of the sudden impact of negotiated rates through the dramatic decline in the price of a NYSE seat,³⁶⁴ and investors would be compensated for losses incurred in any broker bankruptcies under the new mandatory insurance scheme.³⁶⁵

Finally, the *Gordon* court did not focus on the issue of remedies, illustrating the unviability of the choices open to a court under the jurisdictional approach.³⁶⁶ If the Supreme Court remands the case and permits Gordon to proceed with his antitrust suit, a district court may be obliged to order the NYSE to pay treble damages of over one billion dollars.³⁶⁷ Such a huge award seems unfair, because the SEC has had the power to alter exchange rates since 1934³⁶⁸ and did not challenge the minimum commission schedules until 1968.³⁶⁹

360. 498 F.2d at 1309.

361. 498 F.2d at 1309.

362. See note 86 *supra*.

363. See text at notes 96-98 *supra*. For instance, the Second Circuit dismissed an appeal of an SEC letter voicing no objection to the NYSE's proposed changes in its commission rates after more than three years of hearings on that subject. *Independent Investor Protective League v. SEC*, No. 71-1924 (2d Cir. Sept. 28, 1971) (unreported), cited in SENATE STUDY, *supra* note 1, at 209.

364. The price of an NYSE seat, once worth more than \$500,000, has dropped to \$72,000 in recent years. See N.Y. Times, Jan. 12, 1975, § 3, at 13, cols. 4-5 (late city ed.).

365. See Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-III (1970). To the extent that insurance rates are raised to make up deficits in the SIPA fund caused by broker bankruptcies, the costs of an antitrust decision against fixed rates would be passed on in part to investors. Alternatively, such a deficit could be financed by a congressional appropriation, so that the loss would be spread to all citizens.

366. Although the SEC will unfix commission rates as of May 1, 1975, see text at note 325 *supra*, this will not affect Gordon's claims as to damages for past actions of the NYSE. As to future actions, the SEC's decision to terminate fixed rates may be significant even if the Commission's legal authority to do so is successfully challenged by the NYSE. See BNA SEC. REG. & L. REP. No. 286, at A-3 (Jan. 22, 1975). A court could hold that, regardless of the SEC's legal authority to unfix rates, the Commission's regulatory findings mean that minimum rate schedules are no longer "necessary" to the goals of the 1934 Act under *Silver*. See note 33 *supra*.

367. Gordon demanded \$1.5 billion in treble damages and \$10 million in attorneys' fees. Complaint ¶ 22d.

368. See Securities Exchange Act of 1934, § 19(b)(9), 15 U.S.C. § 78s(b)(9) (1970).

369. For a history of objections to minimum commission rates, see R. WEST & S. TINIC, *supra* note 178, at 200-05.

However, if the Court allows Gordon only to appeal SEC orders or decisions on commission rates under section 25 of the 1934 Act or under the Administrative Procedure Act,³⁷⁰ a lower court cannot impose any penalty on the NYSE.³⁷¹ Such lenient treatment also seems unfair, because the NYSE has fixed prices for many years³⁷² and has fought against the SEC's recent efforts to institute negotiated rates.³⁷³

2. *An Alternative Approach to Gordon*

If Congress had enacted the procedures for the revised *Silver* test before the *Gordon* case arose, the court of appeals would not have confronted the Hobson's choice between a treble damage suit against the NYSE and judicial review of SEC discretion. The SEC would have conducted hearings on fixed commission rates³⁷⁴ and the Antitrust Division could have intervened to challenge the SEC's conclusions.³⁷⁵ On appeal, the court would have employed the substantial evidence test to review the Antitrust Division's findings on efficiency losses and the SEC's findings on administrative expenses and regulatory benefits. The court would then have balanced these three factors under the revised *Silver* test. If fixed commission rates survived the test, the plaintiff could later have challenged them only at the periodic SEC review of restrictions on stock transactions.³⁷⁶ If fixed commission rates did not meet the test, they would no longer have been in effect and therefore would not have given rise to Gordon's claim.

While this hypothetical application of the alternative approach to fixed commission rates cannot be described precisely, the analysis

370. Administrative Procedure Act § 10(c), 5 U.S.C. § 704 (1970). See text at notes 61-67 *supra*.

371. See notes 99-100 *supra* and accompanying text.

372. See R. POSNER, *supra* note 213, at 201.

373. For a review of the history of the controversy since 1968, see SEC Securities Exchange Act Release No. 11093 (Nov. 8, 1974), CCH FED. SEC. L. REP. ¶ 80,007. In 1968 and 1969, the NYSE presented the SEC with elaborate briefs defending fixed commission rates. See Baxter, *supra* note 16, at 694. The NYSE refused to comply with the SEC's request to unfix floor brokerage rates in 1974. See SEC Securities Exchange Act Release No. 11073, *supra* note 16, at 84, 547-58 n.3. At the recent SEC hearings on proposed rule 19b-3, the chairman of the NYSE intimated that it will challenge the SEC's authority to unfix commission rates. See BNA SEC. REG. & L. REP. No. 281, at AA-2 (Dec. 11, 1974).

374. See text at notes 321-22 *supra*.

375. See text at notes 290-96 *supra*.

376. See text preceding note 323 *supra*. If Gordon had filed suit before legislative enactment of the revised *Silver* text, the case would be decided under current law even if Congress did enact new procedures. See text at note 320 *supra*.

called for by the revised *Silver* test probably would have taken the following lines. In making findings on efficiency losses, the Justice Department would have attempted to demonstrate the impact of fixed rates on the choice of marketplace for execution. The evidence is fairly strong that fixed rate schedules induced execution of many orders in marketplaces without certain regulatory restrictions, rather than in the most efficient marketplace.³⁷⁷ Since the NYSE's minimum commission schedule exceeded actual transaction costs for large orders,³⁷⁸ institutional investors were driven to regional exchanges and the OTC. Most regional exchanges further attracted trades by permitting institutional investors to become members and execute trades for their own accounts, at actual transaction costs,³⁷⁹ and by offering complicated schemes that allowed institutional investors to direct part of the fixed commissions to nonmember firms for services other than execution.³⁸⁰ To undercut the minimum prices in the NYSE schedule, institutional investors began to negotiate in the "third-market"—they traded for NYSE-listed stocks in the OTC.³⁸¹ In addition, they traded directly among themselves, in the so-called "fourth market."³⁸²

In making findings on regulatory expenses, the SEC would have determined the administrative problems created for the SRO's and the Commission by the minimum fee schedule. To enforce its minimum schedule, the NYSE prohibited institutional ownership of NYSE firms³⁸³ so that funds could not trade for their own accounts at actual transaction costs, and virtually prevented NYSE members from negotiating trades in the third market at prices lower than the NYSE schedule.³⁸⁴ Because of their discriminatory effect on certain investors and marketplaces, these two rules became the subject of

377. See SENATE STUDY, *supra* note 1, at 49-51.

378. See INSTITUTIONAL INVESTOR STUDY, *supra* note 196, pt. 8, at 102. While the NYSE introduced some volume discounts in 1968, there were still substantial differences between actual transaction costs and the NYSE schedule. See SENATE STUDY, *supra* note 1, at 65.

379. For a survey of exchange rules on institutional membership, see SENATE STUDY, *supra* note 1, at 71-73.

380. See INSTITUTIONAL INVESTOR STUDY, *supra* note 196, pt. 8, at 103; Ratner, *supra* note 200, at 356-57.

381. See INSTITUTIONAL INVESTOR STUDY, *supra* note 196, pt. 8, at 91-92.

382. For a discussion of the fourth market, see S. ROBBINS, SECURITIES MARKETS 257-59 (1966). For a description of Instinet, the information system for the fourth market, see R. WEST & S. TINIC, *supra* note 178, at 70-71.

383. See Baxter, *supra* note 16, at 679-83.

384. See NYSE Rule 394, 2 CCH NYSE GUIDE ¶ 2394 (1974). The NYSE has announced recently that it is lessening restrictions against third-market trading by NYSE members. See BNA SEC. REG. & L. REP. No. 272, at A-7 (Oct. 9, 1974).

administrative disputes between the SRO's and the SEC.³⁸⁵ The SEC concluded that it was incapable of reviewing the reasonableness of the minimum fee schedules in a manner similar to a public utility commission.³⁸⁶ The exchanges could not generate appropriate cost data to support their rate schedules and the SEC could not develop adequate criteria for an industry with such a heterogeneous group of firms.³⁸⁷

Two of the alleged regulatory benefits of fixed commission rates would focus on distributional concerns, and therefore would have to overcome a strong negative presumption against implementing distributional goals through stock market restrictions.³⁸⁸ The first distributional argument would be that uniform charges by brokers to all customers give cross-subsidies to individual investors from institutional investors, because of the lower transaction costs for large blocks.³⁸⁹ Since individual stock ownership is more concentrated among the wealthy than the beneficial ownership of most institutional funds,³⁹⁰ however, this cross-subsidy cannot be supported on distributional grounds. Also, institutional investors usually do not employ the same brokers as individual investors,³⁹¹ and under negotiated rates even brokers handling individual customers might execute for fees lower than the NYSE minimum schedule.³⁹² The second distributional argument would be that fixed commissions protect small brokers against destructive competition from large brokers.³⁹³ But the NYSE studies to support this argument have been cogently assailed by Professor Baxter.³⁹⁴ Other studies show that,

385. See Note, *supra* note 51, at 820-25. For a discussion of the dispute over institutional ownership rules, see SENATE STUDY, *supra* note 1, at 64-87.

386. See SENATE STUDY, *supra* note 1, at 47-48.

387. See Justice Comments, *supra* note 346, at 25-31.

388. See text at notes 247-69 *supra*.

389. See SENATE STUDY, *supra* note 1, at 58-59; Baxter, *supra* note 16, at 695.

390. See text at notes 256-60 *supra*.

391. See SENATE STUDY, *supra* note 1, at 58. Therefore no cross-subsidy can result from a uniform charge by a broker to both categories of investors.

392. By providing "bare-bones" execution, without the other services now automatically included in fixed commission charges, see, e.g., text at note 397 *infra*, "discount brokers" have been able to offer individual investors transaction costs lower than the NYSE minimum schedule offers. See N.Y. Times, June 17, 1973, § 3, at 2, cols. 1-8 (late city ed.). The chairman of Merrill Lynch has stated that his firm would be able to offer a straight execution service for individual investors at a lower price under negotiated rates than under the current NYSE minimum schedule. See SENATE STUDY, *supra* note 1, at 59. However, if individual investors actually receive all of the services theoretically included in the fixed commission rates, they will probably pay fees higher than those offered by the NYSE minimum schedule. See N.Y. Times, May 28, 1974, at 55, cols. 1-3 (late city ed.).

393. See SENATE STUDY, *supra* note 1, at 52.

394. See Baxter, *supra* note 16, at 697-703.

because economies of scale are limited in the brokerage industry, many small firms have higher profit margins than the largest brokerage house in the country.³⁹⁵

One key controversy in applying the revised *Silver* test would involve the claim that fixed commission rates promote the high-quality research essential to wise investing.³⁹⁶ Under fixed rates, investors automatically pay a research charge included in the exchange member's brokerage commission; under negotiated rates, investors would generally purchase research information and execution services separately.³⁹⁷ According to some experts, this separation would lead investors to seek the least expensive execution, regardless of the quality of research provided.³⁹⁸ Money managers fear that they may be accused of breaching their fiduciary duties to fund beneficiaries by choosing brokers on the basis of research quality as well as execution cost.³⁹⁹ But a growing body of evidence supports the "random walk theory," which suggests that much securities research is worthless.⁴⁰⁰ The SEC has been approaching the problem of research under negotiated rates by formulating explicit rules on best execution for brokers and money managers.⁴⁰¹ So long as research could be monitored by specific legal rules, the courts should not permit the regulatory benefit argument on research to outweigh the efficiency losses and administrative expenses imposed by fixed commission rates.⁴⁰²

The other key controversy would involve the claim that fixed commission rates preserve the auction market.⁴⁰³ According to the NYSE, negotiated rates would eliminate the primary incentive to join an exchange, the subsequent reduction in membership would decrease the volume of orders in the NYSE, and the lower volume would diminish the opportunity for public matches without dealer

395. See SENATE STUDY, *supra* note 1, at 52-53.

396. See *id.* at 60; BNA SEC. REG. & L. REP. No. 279, at AA-6 (Nov. 27, 1974) (testimony of James Lorie).

397. See HOUSE STUDY, *supra* note 7, at 145.

398. See generally *Hearings on S. 3169, supra* note 184, at 25 (testimony of SEC Chairman William Casey).

399. See SENATE STUDY, *supra* note 1, at 61.

400. For a review of the empirical data on the random walk theory, see sources cited note 210 *supra*. If the price movements of stocks are random, brokers cannot identify securities with superior levels of return and can advise investors only about the appropriate diversification of risk. See Cohen, *supra* note 180, at 1615.

401. See BNA SEC. REG. & L. REP. No. 275, at AA-1 to -2 (Oct. 30, 1974). Cf. S. 249, 94th Cong., 1st Sess. § 24 (1975).

402. See text at notes 314-17 *supra*.

403. See BNA SEC. REG. & L. REP. No. 279, at AA-6 (Nov. 27, 1974) (testimony of James Lorie).

participation.⁴⁰⁴ However, several other groups of experts maintain that members will not flee the NYSE under negotiated rates;⁴⁰⁵ that even if they did, reduced membership would not necessarily mean lower order volume;⁴⁰⁶ and that presently the NYSE floor rarely witnesses public matches without dealer participation.⁴⁰⁷ If the SEC were to reject the NYSE's argument on preserving the auction market, a court would clearly invalidate fixed commission rates under the revised *Silver* test. If the SEC were to accept this argument, the court would face a close case. It could appoint experts to help analyze the data on fixed rates, and could ask the SEC to investigate further the predicted impact of negotiated rates. If the result still remained uncertain, the court should consider that fixed commissions impose substantial costs not easily avoided by market participants in the event of erroneous judicial approval.⁴⁰⁸ The court would therefore be best advised to unfix rates while retaining jurisdiction in the event that the alleged regulatory virtues of the auction market were seriously impaired.⁴⁰⁹

B. *The Transition from Negotiated Rates to the Central Market*

When negotiated rates begin, brokerage firms will compete more actively to provide the best execution for investors.⁴¹⁰ When the central communications system is completed, marketplaces will compete more actively to provide the best execution for brokerage firms.⁴¹¹ Negotiated rates, however, are slated to begin in May 1975⁴¹² and the central communications system will be operational no earlier

404. See NYSE, Research Report on Incentives to Exchange Membership in Central Market System [hereinafter NYSE Research Report], reprinted in *Hearings on S. 2519 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 1st Sess. 456, 468-74 (1973).

405. See *Hearings on SEC Authority over Third Market Trading Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 2d Sess. 9-10 (1974) [hereinafter *Hearings on SEC Authority*]; Letter from Ray Garrett, Jr., SEC Chairman, to Senator Harrison Williams, Dec. 10, 1973, at 9-12.

406. See I. FRIEND & M. BLUME, *supra* note 184, at 342-48; Letter from Ray Garrett, Jr., *supra* note 405, at 10.

407. See note 199 *supra*.

408. See text at note 312 *supra*.

409. *Otter Tail Power Co. v. United States*, 410 U.S. 366, 381 (1973).

410. Cf. text at notes 198-202 *supra*.

411. When the central communications system is operational, computer hardware will permit brokers to compare price information and to clear trades at all marketplaces. See text at notes 469-72 *infra*. The SEC also plans to eliminate the regulatory barriers to competition among marketplaces in the central communications system. See SEC Policy Statement, *supra* note 18, at 46-64.

412. See SEC Securities Exchange Act Release No. 11203, *supra* note 16.

than 1977.⁴¹³ During the transitional period, between the introduction of negotiated rates and the completion of the central communications system, brokerage firms without the computer hardware needed for systematic shopping among marketplaces will compete for investor orders. The Senate has passed legislation giving the SEC authority to restrict third-market trading after the elimination of fixed rates,⁴¹⁴ and both the SEC⁴¹⁵ and the Senate⁴¹⁶ have proposed restrictions on institutional membership.

1. *The Third-Market Bill*

The Senate bill permits the SEC to constrain or prohibit third-market trading—the trading of exchange-listed stocks on the OTC—after the introduction of negotiated rates.⁴¹⁷ The SEC may place constraints on the OTC when “necessary or appropriate in the public interest or for the protection of investors to restore or maintain the fairness and orderliness of the markets for such securities.”⁴¹⁸ The SEC may prohibit third-market trading only after finding that exchange rules do not “unreasonably” impair the ability of OTC dealers to effect stock transactions on exchange floors or to compete on equal terms with exchange specialists.⁴¹⁹ Any SEC regulation affecting the third market would be subject to review in a federal court of appeals under the “necessary or appropriate” standard.⁴²⁰ Because the court will defer to the SEC’s findings under the substan-

413. The central tape system is in its pilot stage, and no plan has been approved for the central quote and central clearing functions.

414. See S. 3126, 93d Cong., 2d Sess. (1972), which was incorporated into S. 249, 94th Cong., 1st Sess. § 6 (1975) (adding section 11(A)(m) to the 1934 Act); *Hearings on SEC Authority*, *supra* note 405. The NYSE has asked the SEC to institute administrative measures along the lines of the third market bill. See BNA SEC. REG. & L. REP. No. 204, at AA-1 (Dec. 11, 1974).

415. See 17 C.F.R. § 240.19b-2 (1974).

416. See S. 249, 94th Cong., 1st Sess. § 5(b) (1975) (adding section 11(a)(1) to the 1934 Act). See also *Hearings on S. 1164 and S. 3347 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 2d Sess. (1972) [hereinafter *Hearings on S. 1164 and S. 3347*].

417. S. 249, 94th Cong., 1st Sess. § 6 (1975) (adding section 11A(c)(4)(C) to the 1934 Act).

418. S. 249, 94th Cong., 1st Sess. § 6 (1975) (adding section 11A(c)(4)(A) to the 1934 Act).

419. S. 249, 94th Cong., 1st Sess. § 6 (1975) (adding section 11A(c)(4)(A) to the 1934 Act). The Commission must find “that no rule of any national securities exchange unreasonably impairs the ability of any dealer to solicit or effect transactions in such securities for his own account or unreasonably restricts competition among dealers in such securities or between dealers acting in the capacity of market makers who are specialists in such securities and such dealers who are not specialists in such securities.”

420. Any SEC rule promulgated under section 11A would be subject to direct judicial review in a court of appeals under the substantial evidence rule. S. 249, 94th Cong., 1st Sess. § 19 (1975) (amending section 25(b)(1) of the 1934 Act).

tial evidence rule, restrictions on the OTC will be difficult to overturn as long as the SEC properly protects the record. Any SRO following an SEC restriction on third-market trades, however, would be subject to an antitrust suit under the *Silver* "necessity" standard.⁴²¹ Thus, the possibility of conflicting decisions still exists under the proposed bill.

In contrast, if Congress enacted the procedures for the revised *Silver* test, an authorized SEC restriction on the third market would be subject only to judicial review in a court of appeals, which would balance the efficiency losses as presented by the Antitrust Division against the regulatory benefits of a third-market restriction as put forward by the SEC.⁴²² There is considerable evidence that restrictions on the third market would not dramatically alter the allocation of small round-lot orders in NYSE stocks among marketplaces. Any marketplace can attract orders through economies of scale derived from a high volume of orders⁴²³ of roughly the same size.⁴²⁴ The NYSE will most likely be the one to reap these economies of scale during the transition period: Many large brokerage firms will probably continue their current practice of funneling small round-lot orders in NYSE stocks to that exchange⁴²⁵ until required to engage in comparative shopping through the central communications system.⁴²⁶

Restrictions on trading large blocks of shares in the third market, however, would probably produce substantial deviations from a competitive allocation of trades. Market makers in the OTC seem to have inherent advantages over exchange specialists in the execu-

421. The Senate Report emphasizes that SEC consideration of competitive factors does not preclude de novo review of antitrust claims against SRO conduct even if that conduct "has been approved or required by the SEC." NATIONAL MARKET REPORT, *supra* note 163, at 11.

422. See text at notes 302-04 *supra*.

423. See R. DOEDE, *supra* note 324, at 452-53; Baxter, *supra* note 16, at 708; Demsetz, *supra* note 176, at 50.

424. A high volume of orders generally will reduce transaction costs because there will be more perfect matches of public orders and less need for dealer participation. Cf. R. WEST & S. TINIC, *supra* note 178, at 145. If the incoming orders are of very different sizes, however, transaction costs will rise because there is a much lower probability of perfect matches and a much greater need for dealer participation. Cf. *id.* at 146.

425. Interview with Neil See, Vice-President of Merrill Lynch, Pierce, Fenner & Smith, New York City, March 20, 1974. See BNA SEC. REG. & L. REP. No. 279, at AA-7 (Nov. 27, 1974) (testimony of Professor Seymour Smidt).

426. Cf. text at note 411 *supra*. The only efficiency loss would be the elimination of a competitive threat to NYSE specialists. As a 1971 study showed, the entry of 30 NYSE-listed stocks on NASDAQ led to the reduction of spreads by NYSE specialists. Weeden & Co. Inter-Office Memorandum, Fred Siesel to Donald E. Weeden, June 8, 1971 [hereinafter Weeden & Co. Memo].

tion of very large orders.⁴²⁷ Tied to the exchange floor, specialists often cannot match very large orders with other incoming orders and may be unwilling to risk a huge percentage of their own inventories in one trade.⁴²⁸ In the more flexible OTC, market makers can search for matches, use lower proportions of their own inventories, and negotiate price or size changes among the parties to the trade.⁴²⁹

A restriction on the third market would also create serious administrative problems. Although prices of NYSE-listed stocks easily could be removed from the OTC's computerized quote system,⁴³⁰ elimination of trading in NYSE-listed stocks throughout the rest of the OTC would prove more difficult. The OTC includes about 4,000 broker-dealers scattered throughout the country.⁴³¹ Even if the SEC could confine trading in NYSE-listed stocks to the NYSE, the absence of competitive checks from the OTC would require more intensive regulation of NYSE specialists—a development that has been difficult to achieve in the past.⁴³²

The chairman of the NYSE has maintained that restrictions are needed to protect investors under negotiated rates.⁴³³ According to the NYSE, any increase in OTC executions at the expense of the exchange will impose higher transaction costs on investors.⁴³⁴ While these studies explain why the NYSE will probably continue to attract many transactions under negotiated rates, other studies conclude that increased competition among marketplaces under negotiated

427. Although block trading firms of the NYSE now play roles similar to those of market makers in the OTC, they consummate their trades in their "upstairs offices" and then must bring their trades to the exchange floor so that the specialist's book can be cleared of orders. Thus, the exchange and the specialists have become functionally dispensable in the disposition of many large orders. See Mendelson, *Nostalgia vs. the Computer: The Issue of Stock Market Reform*, 1971 SEC. L. REV. 503, 508-10. See also R. WEST & S. TINIC, *supra* note 178, at 218-20; Fiske, *Can the Specialist Cope with the Age of Block Trading?*, INSTITUTIONAL INVESTOR, Aug. 1969, at 29, 33-34.

428. See Mendelson, *supra* note 427, at 508-10. Cf. R. WEST & S. TINIC, *supra* note 178, at 217-18.

429. "This ability to take a heavy position, or to negotiate a large deal on an agency basis, undoubtedly constitutes the single attribute of the [third] market makers most important to their institutional customers." SPECIAL STUDY, *supra* note 1, pt. 2, at 894-95.

430. See generally notes 5-6 *supra*.

431. This represents the combined membership of NASD and SECO. See note 10 *supra*. Any broker or dealer is a potential participant in the third market, although NYSE Rule 394 effectively bars third-market trading by NYSE members. See note 384 *supra* and accompanying text.

432. See SENATE STUDY, *supra* note 1, at 183-84.

433. See *Hearings on SEC Authority*, *supra* note 405, at 79-101 (testimony of James Needham). The vast majority of third-market stocks are listed on the NYSE. AMEX stocks are not traded heavily in the OTC, and the regional exchanges tend to trade heavily in NYSE-listed stocks. See SENATE STUDY, *supra* note 1, at 91-93.

434. See NYSE Research Report, *supra* note 404, at 503-10.

rates would probably offset any deleterious effects on transaction costs caused by decreases in NYSE volume.⁴³⁵ Similarly, the NYSE argues that the OTC cannot offer investors the greater regulatory protection available at exchanges.⁴³⁶ Some of the unique protections once afforded by exchanges, however, have been superseded by uniform rules for all marketplaces, such as the recent SEC rule on short sales.⁴³⁷ Although OTC dealers are not subject to the restrictions on market making applied to NYSE specialists, these restrictions are needed to regulate the trading monopolies given to specialists.⁴³⁸ Competition among OTC dealers in the same NYSE stock arguably provides as effective a check on market making.⁴³⁹

Thus, courts applying the revised *Silver* test should be unreceptive to restrictions on the trading of large blocks of securities by institutional investors. Restrictions would seriously distort trading efficiency and would create a difficult enforcement problem. Institutional investors that are managed by professionals and possess some bargaining power do not appear to need regulatory protection against the alleged vagaries of the OTC.⁴⁴⁰ If the SEC restricts only third-market trading of small round-lot orders in high-volume stocks,⁴⁴¹ the courts would face a much closer question, because such a restriction would arguably not distort the allocation of trades among marketplaces. Before making a decision in the latter case, the court should ask the SEC to monitor closely the impact of negotiated rates on such orders. If the regulatory concerns of the NYSE materialize, the courts should validate the SEC restriction until completion of the central communications system, when a new analysis of trading patterns would be needed.⁴⁴²

435. See I. FRIEND & M. BLUME, *supra* note 184, at 353-54; R. WEST & S. TINIC, *supra* note 178, at 162; Weeden & Co. Memo, *supra* note 426.

436. See NYSE Research Report, *supra* note 404, at 489-92.

437. 17 C.F.R. § 240.10a-1 (1974). See also 17 C.F.R. § 240.17a-15 (1974), requiring that all exchanges submit plans for reporting last sale information.

438. See *Hearings on SEC Authority*, *supra* note 405, at 171, 175-77.

439. Moreover, the SEC has stated that it is planning to require more regulatory controls on market making in the OTC. See *id.* at 178. Compare text at note 432 *supra*.

440. The SEC has argued against institutional membership precisely because institutional investors were perceived as having too much power over other market participants. See SEC Securities Exchange Act Release No. 9950, *supra* note 51.

441. See, e.g., BNA SEC. REG. & L. REP. No. 250, at A-16 to -17 (May 1, 1974).

442. Under the Senate bill, the SEC's authority to restrict third-market trading will end when "the Commission has determined that a national market system for securities has been established or April 30, 1978, whichever is earlier . . ." S. 249, 94th Cong., 1st Sess. § 6 (1975) (adding section 11A(c)(4)(C) to the 1934 Act). The SEC's authority may be extended beyond April 30, 1978, until a national market system is established, if the Commission finds that "such extension is necessary or appropriate in the public interest or for the protection of investors . . ." But see text at notes 420-21 *supra*.

2. Institutional Membership on Exchanges

The SEC has recently promulgated rule 19b-2, requiring that exchange members have "as the principal purpose of [their] membership" the conduct of a public securities business.⁴⁴³ A member may satisfy this criterion by executing no more than twenty per cent of its transactions for its own account or for "affiliated" accounts.⁴⁴⁴ Because the SEC has developed a lengthy statement in support of the rule's regulatory goals and has protected the record by considering competitive factors,⁴⁴⁵ it seems unlikely that a court using current procedures would overturn the new rule.⁴⁴⁶ The reviewing court must defer to the SEC's conclusions concerning competitive effects if those findings are supported by substantial evidence,⁴⁴⁷ notwithstanding opposition by the Justice Department.⁴⁴⁸ While an antitrust suit against an SRO adhering to the SEC rule would permit a more independent analysis of competitive factors by the court,⁴⁴⁹ a decision against the SRO could conflict with affirmance of the SEC's rule by another court,⁴⁵⁰ and the award of treble damages would unfairly penalize an SRO that had relied on the rule.⁴⁵¹

If the procedures for the revised *Silver* test were in effect, however, the SEC's rule would come before only one court, which would balance the efficiency losses against regulatory considerations. Under negotiated rates, firms would compare the cost of executing their own trades with the price charged by brokers. If regulatory restrictions are placed on the type of firms that can join exchanges,⁴⁵² some efficiency losses will result because a number of firms will be paying more for brokerage services than they would for in-house execution.⁴⁵³ In addition, restrictions on institutional membership

443. 17 C.F.R. § 240.19b-2 (1974).

444. 17 C.F.R. § 240.19b-2(a) (1974). See SEC Securities Exchange Act Release No. 9950, *supra* note 51, at 82, 83.

445. See SEC Brief, *supra* note 98, at 76-88.

446. See note 98 *supra* and accompanying text. A regional exchange is appealing rule 19b-2, however. See note 67 *supra*.

447. See note 39 *supra* and accompanying text.

448. The Justice Department could argue only that the SEC was applying an incorrect legal standard to the facts. See text at notes 133-52 *supra*.

449. See text at notes 85-89 *supra*.

450. One district court has dismissed an antitrust claim involving NYSE membership rules because the SEC was exercising jurisdiction over the subject matter and its decision would be subject to direct judicial review. See *Robert W. Stark, Jr., Inc. v. NYSE*, 346 F. Supp. 217 (S.D.N.Y. 1972).

451. See notes 90-91 *supra* and accompanying text.

452. The proposed legislation also gives the SEC authority to prohibit trading for affiliated accounts on the OTC. S. 249, 94th Cong., 1st Sess. § 5 (1975) (amending section 11(a)(2)(B) of the 1934 Act).

453. Some institutional members on exchanges would apparently choose not to remain members after the elimination of fixed rates even if they could negotiate access

will impose new administrative expenses, albeit of low magnitude. The SEC might have to apply a control test to the contractual arrangements and informal practices used by excluded firms,⁴⁵⁴ thus preventing institutional investors from reaping the benefits of exchange membership by other means.

The prime danger of the institutional membership rule stems from the vulnerability of regional exchanges during the period between commencement of negotiated rates and the completion of the central communications system.⁴⁵⁵ The opportunity for institutional membership is one of the few advantages that the regionals enjoy over other marketplaces.⁴⁵⁶ Negotiated rates will remove the incentive for institutional trading on regional exchanges to avoid the NYSE minimum commission schedule.⁴⁵⁷ Active OTC dealers, rather than passive exchange specialists, probably will handle large orders from institutional investors.⁴⁵⁸ Regionals will have difficulty competing with the NYSE for small round-lot orders because many of these orders will be funneled routinely to the NYSE until the commencement of the central communications system.⁴⁵⁹ Regionals could play an important role once that system is operative, however, because brokers would be required to discover the best marketplace and investors would be able to compare executions at different

to exchange floors. Telephone interview with Frank Romano, chief securities trader for National Life Insurance Company of Vermont, an institutional member of the PBW Exchange, June 7, 1974.

454. For example, S. 249, 94th Cong., 1st Sess. § 5 (1975) (amending section 11(a)(1) of the 1934 Act) prohibits any exchange member from trading on the exchange for any account "in which it or an associated person thereof exercises investment discretion" An "associated person" of a member includes "any person directly or indirectly controlling, controlled by, or in common control with such member" S. 249, 94th Cong., 1st Sess. § 3(d) (1975).

Rule 19b-2 presumes that a person who "has a right to participate to the extent of more than 25 per cent in the profits of [another] person or owns beneficially, directly or indirectly, more than 25 per cent of the outstanding securities of [another]" controls the other person. 17 C.F.R. § 240.19b-2(2) (1974).

455. See BNA SEC. REG. & L. REP. No. 280, at F-1 (Dec. 4, 1974) (testimony of E. Wetherill, President of the PBW); BNA SEC. REG. & L. REP. No. 278, at G-1 (Nov. 20, 1974) (testimony of Michael Tobin, President of the Midwest Stock Exchange).

456. See *Hearings on S. 1164 and S. 3347*, *supra* note 416, at 403-04 (testimony of D. Farrar, former Director of the Institutional Investor Study); Wetherill & Hender, *Institutional Membership and the Experience of the Philadelphia-Baltimore-Washington Stock Exchange*, 13 B.C. IND. & COM. L. REV. 1021, 1024-26 (1972).

457. Under fixed rates, institutional investors sought exchange membership to recapture commissions. See text at note 379 *supra*. Some have argued that the fiduciary duties of money managers required them to seek exchange membership for their funds. See Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U. L. REV. 35, 50-55 (1971).

458. See text at notes 427-29 *supra*.

459. See text at notes 423-26 *supra*.

marketplaces.⁴⁶⁰ To ensure the survival of regionals as a potentially competitive force until the central communications system becomes operational, these exchanges need flexibility in allowing institutional membership.⁴⁶¹

The SEC has made two regulatory arguments for the rule restraining institutional membership. First, it maintains that exchange membership furnishes institutional investors with special advantages over individual investors through better access to new information and to the trading floor.⁴⁶² But major studies reveal that the profits of most institutional investors have been below market averages,⁴⁶³ and no study shows that the above-average performance of certain funds is attributable to their exchange memberships rather than to other attributes of large funds, such as full-time managers. The second regulatory argument is stronger: Combining the functions of money management and stock brokerage creates conflicts of interest injurious to fund beneficiaries and to other customers of the brokerage firm.⁴⁶⁴ An institutional manager could "dump" the stock held by the fund to help position a large block for another customer; alternatively, an institutional manager could urge other customers to purchase a flagging stock in the fund's portfolio.

Application of the revised *Silver* test would warrant invalidation of rule 19b-2 because that rule does not achieve either of its stated regulatory benefits.⁴⁶⁵ The rule does not eliminate the alleged trading advantages of institutional membership because institutional investors could easily circumvent the twenty per cent criterion by purchasing a brokerage house with a large public business. If institutional investors make such purchases in order to become exchange members, then conflicts of interest between fund beneficiaries and public customers will multiply.⁴⁶⁶

460. See text at notes 410-11 *supra*.

461. The regionals have introduced some devices to cope with the threat of negotiated rates before the completion of the central communications system. See BNA SEC. REG. & L. REP. No. 279, at A-1 (Nov. 27, 1974).

Another reason to preserve regional exchanges is that they have been major innovators in the recent history of the securities industry. See generally BNA SEC. REG. & L. REP. No. 280, at F-2 (Dec. 4, 1974).

462. See SEC Securities Exchange Act Release No. 9950, *supra* note 51, at 114-26. To the extent that the SEC's argument against institutional investors is based on a distributional concern for small investors, the argument is misplaced. The beneficiaries of many institutional funds are in the same or lower income brackets than most individual investors. See text at notes 252-60 *supra*.

463. See, e.g., I. FRIEND, M. BLUME & J. CROCKETT, MUTUAL FUNDS AND OTHER INSTITUTIONAL INVESTORS 20, 50-59 (1970).

464. See SENATE STUDY, *supra* note 1, at 75-76.

465. See text at note 306 *supra*.

466. An additional difficulty of rule 19b-2 emerges from an apparently arbitrary

An SEC restriction based on the recent Senate bill concerning institutional membership would fare much better. By generally forbidding a member to conduct any business on an exchange for its own account or that of an affiliated person,⁴⁶⁷ the Senate bill more adequately responds to the two main regulatory arguments against institutional membership than does rule 19b-2. The prohibition on trading for one's own account or for "affiliated" accounts would eliminate the alleged advantages derived from exchange membership by institutional investors, and would decrease the conflicts of interest between fund beneficiaries and public customers. If the SEC issued a regulation based on the Senate bill after completion of the central communications system, it should clearly be validated under the revised *Silver* test because its adverse effects would be minimal. If the SEC issued such a regulation during the period between the institution of negotiated rates and the operation of the central communications system, however, the danger posed to the survival of regional exchanges would complicate the case. The regulation should nevertheless be upheld because the detailed Senate bill would represent an implicit congressional judgment that the regulatory benefits of the membership restriction outweigh its costs.⁴⁶⁸

C. *The Central Communications System: A Case Study*

The SEC has proposed that all existing marketplaces be linked by a central communications system.⁴⁶⁹ This system would provide three services: a consolidated tape on last sale information,⁴⁷⁰ a composite report on current quotes,⁴⁷¹ and a common clearing network for processing stock transfers.⁴⁷² While there is a consensus

distinction in the SEC's definition of "affiliated persons" for the purpose of the 20 per cent criterion. The term excludes pension funds managed by brokerage firms, *see* SENATE STUDY, *supra* note 1, at 82, but includes pension funds managed by insurance companies. This distinction was reportedly inserted at the suggestion of the NYSE, whose members frequently manage pension funds. *See id.*

467. S. 249, 94th Cong., 1st Sess. § 5 (1975) (amending section 11(a) of the 1934 Act). The bill contains exceptions for specialists, block positioners, and other securities professionals.

468. *See* text at notes 309-11 *supra*.

469. *See* SEC Policy Statement, *supra* note 18; SEC Statement on Future Market Structure, *supra* note 18.

There have also been discussions concerning development of a central execution system that would merge all existing marketplaces into one computer. The central computer would be combined with the tape, quote, and clearing functions of the central communications system. *See* Black, *Toward a Fully Automated Exchange*, 1971 SEC. L. REV. 540, 550-62; Mendelson, *supra* note 427, at 512-24.

470. *See* SEC Exchange Act Release No. 9530 (March 8, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,600.

471. *See* SENATE STUDY, *supra* note 1, at 101-04.

472. *See id.* at 39-42.

among public officials and industry representatives regarding the general desirability of a central market,⁴⁷³ serious debate exists concerning its precise form and management.⁴⁷⁴ A study of the consolidated tape service—the only segment of the central communications system completed thus far⁴⁷⁵—provides some useful insights into the arguments that will probably be made with respect to other aspects of the proposal for a central communications system.⁴⁷⁶

1. *The Current Approach to the Consolidated Tape*

If the goal of the central tape plan were solely to maximize competition, the SEC would simply require that all SRO's provide last trade information to any firm interested in marketing such information and willing to follow the basic format for the tape.⁴⁷⁷ Indeed, the SEC originally envisaged precisely this type of arrangement for the production and distribution of the tape among vendors of last-trade information.⁴⁷⁸ The final plan approved by the SEC,⁴⁷⁹

473. See *id.* at 89: "Recent discussion of the market structure of the future has reflected virtually unanimous sentiment in favor of a 'central market system.'"

474. The SEC advocates a system that will retain the existing marketplaces. See SEC Statement on Future Market Structure, *supra* note 18, at 7-8. The NYSE, on the other hand, has conceived of the central market in terms of one national exchange. See W. MARTIN, *THE SECURITIES MARKET: A REPORT, WITH RECOMMENDATIONS* 5-16 (1971). See generally BNA SEC. REG. & L. REP. No. 258 (June 26, 1974) (Special Supp.).

475. The central tape began a six-month pilot phase on October 18, 1974. See SEC Securities Exchange Act Release No. 11036 (Oct. 3, 1974), [Current] CCH FED. SEC. L. REP. ¶ 79,973. While the full tape system was scheduled to be operational on February 21, 1975, completion has been postponed to July 1, 1975. See BNA SEC. REG. & L. REP. No. 282, at AA-5 (Dec. 18, 1974).

476. The SEC has issued a rule on the central quote system, but no plan has yet been approved. See SEC Securities Exchange Act Release No. 10969 (Aug. 14, 1974), [Current] CCH FED. SEC. L. REP. ¶ 79,931. The SEC has only issued a memorandum on the central clearing function. See SEC Securities Exchange Act Release No. 10631 (Feb. 7, 1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,643.

477. The private vendors would put together various packages of last sale information and vie for subscribers on the basis of price and quality of informational services. Subscribers would pay only for the package of information best suited to their needs, at a competitively determined price. The SEC would have to ensure only that the basic format for the central tape was followed by any vendor of last sale information. A substantial number of vendors already have an interest in processing and distributing data on last trades. See letters in SEC File No. 4-147 from Robert Haring, Business News Editor, Associated Press, Sept. 25, 1972; J.T. Lawson, President of General Telephone and Electronic Information Systems, Sept. 28, 1972; Milton Mohr, President of Scantlin Electronics, Inc., May 4, 1973; Richard Paul, on behalf of Instinet, April 6, 1973; Anthony Barnett, Vice-President of Bunker-Ramo, April 6, 1973; Dr. A. Kay, President of AUTEX, April 6, 1973; B.V. Borngesser, Systems Manager Securities, IBM, March 23, 1973.

478. See BNA SEC. & REG. L. REP. No. 258, at 7 (June 26, 1974) (Special Supp.).

479. After issuing proposed rule 17a-15, SEC Securities Exchange Act Release No. 9530, *supra* note 470, the SEC began a series of negotiations with the proponents of a plan for the central tape, mainly the NYSE and AMEX. See SEC Securities Exchange Act Release No. 10218 (June 13, 1973), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,397; SEC Securities Exchange Act Release No. 10671 (March 8, 1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,700. Finally, the SEC approved the

however, stipulates that the central tape will be managed by the Securities Industry Automation Corporation (SIAC), a corporation owned two thirds by the NYSE and one third by the AMEX.⁴⁸⁰ The SRO's will send the prices of last trades in selected securities only to SIAC,⁴⁸¹ which will produce a consolidated tape divided into two data streams—one for NYSE-listed stocks and one for AMEX-listed stocks plus certain other issues.⁴⁸² SIAC will have the exclusive right to sell these data streams on a continuous basis, that is, through the ticker tape.⁴⁸³

The procedures adopted in formulating the plan were ill-suited for reconciling competitive and regulatory factors with respect to the consolidated tape. While the SEC was advocating the central communications system,⁴⁸⁴ the SRO's were reaching a deadlock on the format for a consolidated tape, the first step in the central market plan.⁴⁸⁵ The SEC therefore issued rule 17a-15,⁴⁸⁶ mandating that the SRO's develop a central tape plan under section 17 of the 1934 Act. That section, however, requires submission of written reports by the securities industry, and does not clearly envisage construction of a computerized information network.⁴⁸⁷ Moreover, since any central

plan submitted by the exchanges. SEC Securities Exchange Act Release No. 10787 (May 10, 1974), [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,782. Since the plan was approved, the SEC has ratified a plan amendment relating to NASD rules on reporting of market information, SEC Securities Exchange Act Release No. 11061 (Oct. 18, 1974), 39 Fed. Reg. 38299 (1974); and has issued an amendment to rule 17a-15 providing for appeals to the Commission on certain matters relating to the tape. SEC Securities Exchange Act Release No. 11097 (Nov. 13, 1974), [Current] CCH FED. SEC. L. REP. ¶ 80,008.

480. See PLAN SUBMITTED PURSUANT TO RULE 17a-15 OF SECURITIES AND EXCHANGE COMMISSION UNDER SECURITIES EXCHANGE ACT OF 1934, §§ IV(a)-(b) (April 22, 1974) [hereinafter CENTRAL TAPE PLAN].

481. *Id.* § VII(a).

482. *Id.* § V(a).

483. To obtain the tape, a subscriber will pay a standard yearly fee to the NYSE or AMEX and agree not to engage in retransmission of the tape. A subscriber who wishes to display the tape for its customers will have to rent hardware from private vendors. These vendors will be prohibited from retransmitting the ticker tape, although they can use the tape as the data base for interrogation services, which provide a subscriber with specific information on particular stocks. *Id.* § VIII.

484. See materials cited note 18 *supra*.

485. See SENATE STUDY, *supra* note 1, at 97.

486. 17 C.F.R. § 240.17a-15 (1974).

487. Every national securities exchange, every member thereof, every broker or dealer who transacts a business in securities through the medium of any such member, every registered securities association, and every broker or dealer registered pursuant to section 15 of this title, shall make, keep, and preserve for such periods, such accounts, correspondence, memoranda, papers, books, and other records, and make such reports, as the Commission by its rules and regulations may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, § 17(a), 15 U.S.C. § 78q(a) (1970).

Securities Exchange Act of 1934, § 19(b)(8), 15 U.S.C. § 78s(b)(8) (1970), permits the

market threatens the NYSE's dominance, and the central tape jeopardizes about fourteen million dollars of its annual profits,⁴⁸⁸ the NYSE successfully threatened to delay the start of the central market by challenging the consolidated tape unless SIAC was made the exclusive processor.⁴⁸⁹

The SEC formulated the central tape plan through negotiations with the NYSE,⁴⁹⁰ which are continuing on related regulatory matters.⁴⁹¹ The SEC did not hold a hearing on rule 17a-15, although it did invite comments from interested parties.⁴⁹² Nor did it accept comments by the Senate Subcommittee on Securities,⁴⁹³ the Justice Department,⁴⁹⁴ or its own advisory committee⁴⁹⁵ advocating that a neutral body manage the consolidated tape to avoid discrimination among competing marketplaces. The SEC did not investigate adequately the need to organize tape production and distribution

SEC to alter or supplement exchange rules relating to ticker tapes. Use of its authority under this section would have left the SEC plan less vulnerable to challenge. Apparently the SEC avoided this strategy because the procedures required under section 19(b) were considered too time-consuming. This conclusion was confirmed by personal interviews in Washington, D.C., with Barry Levine, SEC Branch Chief, Market Structure, Division of Market Regulation, April 9, 1974; Robert Lewis, Assistant Director of the SEC's Division of Market Regulation, April 3, 1974; John Liftin, then Associate Director of the SEC's Division of Market Regulation, March 8, 1974 [hereinafter Interviews]. The weakness of the SEC's position under section 17, however, led to three years of negotiations between the SEC and the NYSE. See notes 490-91 *infra* and accompanying text.

488. See Letter from Jay Rosen, GTE Information Systems, to John Liftin, SEC Associate Director, Division of Market Regulation, Feb. 1, 1973.

489. Wall St. J., Dec. 20, 1972, at 8, col. 2 (eastern ed.).

490. For a history of the negotiations between the SEC and the NYSE leading to the approval of the central tape plan, see SEC Securities Exchange Act Releases Nos. 10218, 10671, *supra* note 479. After agreement was reached between the SEC, the NYSE, and the AMEX, the NYSE solicited the support of several regional exchanges, which acquiesced because they, like the SEC, wanted the central market to start as soon as possible. See, e.g., Letter of Michael Tobin, President of the Midwest Stock Exchange, to J. Bradford Cook, SEC Chairman, March 1, 1973. The NYSE never asked some regional exchanges, such as the Boston Stock Exchange, to agree to the central tape plan. See BNA SEC. REG. & L. REP. No. 258, at 8 (June 26, 1974) (Special Supp.).

491. Although the consolidated tape is now in its pilot phase, the SEC is faced with another round of negotiations before the full consolidated tape plan can begin. The SEC issued a uniform rule for short-selling on transactions reported via the consolidated tape, SEC Securities Exchange Act Release No. 11030 (Sept. 27, 1974), [Current] CCH FED. SEC. L. REP. ¶ 79,971, but it has been forced to suspend the effectiveness of this rule, SEC Securities Exchange Act Release No. 11056 (Oct. 17, 1974), [Current] CCH FED. SEC. L. REP. ¶ 79,984, because of criticisms leveled by the NYSE. See BNA SEC. REG. & L. REP. No. 273, at D-1 (Oct. 16, 1974) (NYSE letter to the SEC).

492. See SEC Securities Exchange Act Release No. 9530, *supra* note 470. The written comments are contained in SEC File No. 4-147.

493. See SENATE STUDY, *supra* note 1, at 100.

494. See Comments on Proposed Rule 17a-15 by Thomas A. Kauper, Assistant Attorney General, Department of Justice, at 7-9 (Sept. 29, 1972).

495. ADVISORY COMMITTEE ON MARKET DISCLOSURE ON A COMPOSITE REPORTING SYSTEM, REPORT TO THE SEC (July 17, 1972), reprinted in BNA SEC. REG. & L. REP. No. 161, at E-1 (July 19, 1972).

through a monopoly; nor did it grapple with the problem of setting rates for a tape monopolist, which will put the SEC in the position of a public utility commission.⁴⁹⁶ Moreover, the SEC asked the NYSE for a position paper explaining the main regulatory arguments in defense of SIAC's exclusive role, and adopted many of the NYSE's arguments as its own.⁴⁹⁷

2. *An Alternative Approach to the Consolidated Tape*

If the revised *Silver* test were in effect, the SEC would have followed very different procedures in formulating a tape plan. It first would have held public hearings in which the Justice Department probably would have criticized the plan's anticompetitive aspects. If the SEC did not change the plan in response to these criticisms, the Justice Department could have begun its own proceedings to assess the plan's efficiency aspects.⁴⁹⁸ If the Justice Department found that the plan was anticompetitive, it would have been in a strong position to bargain with the SEC, and the latter could have used the Justice Department's opposition as leverage in its negotiations with the NYSE.⁴⁹⁹ If the SEC still supported SIAC as the exclusive processor and distributor of the tape, private vendors could have employed the adverse findings by the Justice Department in appealing the SEC's decision. The appellate court would have balanced the efficiency loss and administrative expense of the tape plan against its regulatory virtues.

a. *Efficiency loss and administrative expense.* By granting SIAC a monopoly in processing and distributing the consolidated tape, the plan eliminates the checks on performance that competition might otherwise provide. The plan does not even permit bidding for the right to run the tape monopoly, which would impose some competitive restraint.⁵⁰⁰ On the contrary, the plan presents the NYSE and AMEX with ample opportunities to use SIAC's monopoly power against competing marketplaces.⁵⁰¹ Similarly, the plan gives the own-

496. See text at notes 518-21 *infra*. These conclusions were confirmed during Interviews, *supra* note 487.

497. See text at notes 523-32 *infra*. Compare Letter from the NYSE and AMEX to the SEC, June 1, 1973, with SEC Securities Exchange Act Release No. 10671, *supra* note 479.

498. See text at notes 292-93 *supra*.

499. See text at note 296 *supra*.

500. See generally Demsetz, *Why Regulate Utilities?*, 11 J. LAW & ECON. 55 (1968).

501. For a survey of the critiques by other marketplaces leveled at the selection of SIAC as tape processor, see BNA SEC. REG. & L. REP. No. 258, at 7-9 (June 26, 1974) (Special Supp.). The NYSE and AMEX must approve subscribers to the tape who were not previously subscribers to the NYSE or AMEX tapes, see CENTRAL TAPE PLAN, *supra* note 480, § VIII(d), and SIAC has the right to charge regional exchanges or the NASD the cost of running the tape after trading hours end in New York City. *Id.* § X(b).

ers of SIAC considerable leverage over potential competitors in the business of supplying last sale information.⁵⁰² The SEC's designation of SIAC as the central tape processor will also create serious barriers to achieving an efficient organization of the two future communications functions (the central quote reporter and the common clearing network). SIAC recently argued that it should run the central quote reporter to reap the efficiency advantages gained through its role as tape processor.⁵⁰³ If the SEC gives SIAC the central quote function without competitive bidding, however, it will be impossible to ascertain whether SIAC in fact is the most efficient choice.⁵⁰⁴ Even if the SEC takes competitive bids on the central quote function, SIAC could potentially make the lowest bid by hiding costs for the central quote function in its prices for the central tape function, which are set on a cost-plus basis.⁵⁰⁵

Instead of imposing competitive checks on the central tape function, the plan establishes a new regulatory body—the Consolidated Tape Association (CTA)—to supervise SIAC's operations.⁵⁰⁶ The initial governing board of the CTA has eight voting members—two from the NYSE, two from the AMEX, and one from each of the four other participating SRO's.⁵⁰⁷ Since the affirmative vote of at least five of the eight members is required for any action,⁵⁰⁸ CTA action may be effectively blocked by the NYSE and AMEX—the owners of SIAC. In addition, any SRO reporting fifty-one per cent or more of the transactions on either data stream has a veto over any amendment to the plan.⁵⁰⁹ This provision virtually assures that the NYSE and AMEX may combine to veto any amendment to the plan in the near future.⁵¹⁰

502. In general, the plan gives SIAC a monopoly over the distribution of the tape on a continuous basis, but does not prevent SIAC from competing with private firms in the interrogation business. Such competition might give rise to many of the issues raised by the recent suit against American Telephone & Telegraph, which has an approved monopoly over telephones but is seeking to expand into related fields in competition with private firms. See N.Y. Times, Nov. 21, 1974, at 1, col. 6 (late city ed.).

503. See BNA SEC. REG. & L. REP. No. 263, at A-5 (July 31, 1974) (remarks of Robert Hall, SIAC chairman).

504. The NASD, for example, has gained relevant experience in running a computerized quote system for the OTC. See BNA SEC. REG. & L. REP. No. 273, at A-4 (Oct. 16, 1974).

505. Cf. Irwin & McKee, *Vertical Integration and the Communications Industry*, 53 CORNELL L. REV. 446, 448-49 (1968); Tribing, *Common Carrier Regulation—The Silent Crisis*, 34 LAW & CONTEMP. PROB. 299, 314-16 (1969).

506. See CENTRAL TAPE PLAN, *supra* note 480, §§ III(a), IV(a).

507. See *id.*, Exhibit A, art. III, § 1 (articles of association).

508. See *id.* § III(a).

509. See *id.* § III(b).

510. While the plan permits the distribution of voting and veto power to change over time, any change is unlikely before completion of the central communications

During the first five years of the tape's operation, the CTA is empowered to hold SIAC accountable for the tape expenditures.⁵¹¹ According to the fiscal structure of the plan, if SIAC can keep costs about one million dollars below revenues, the NYSE and AMEX will receive all of the profits from the consolidated tape for this time period.⁵¹² Verification of SIAC's cost figures will be a difficult task, as illustrated by the American experience with public utilities and defense contracts.⁵¹³ The CTA will face especially complex problems in determining costs for the central tape because SIAC performs all of the computer work for the NYSE and AMEX, including the development of other central market functions.⁵¹⁴ After five years, the CTA theoretically can end SIAC's monopoly over the ticker tape.⁵¹⁵ As demonstrated by the FCC's practice with respect to renewals of licenses, however, an incumbent monopolist can bring to its defense a well-developed group of political supporters, as well as claims based on investments made in reliance on its continued franchise.⁵¹⁶ In

system. The plan would give another SRO two seats on the board and a veto over amendments if it reported the majority of transactions on either data stream. *Id.*, Exhibit A, art. III, § 1. However, the plan does not allow any changes in the board until five years after the central tape has been fully operative. *Id.* The plan designates one data stream for NYSE-listed stocks only, *id.* § V(a)(i), thus giving the NYSE a tremendous advantage over all other SRO's as far as reporting a majority of the transactions on this stream. The plan weights the second stream heavily in favor of the AMEX, because all AMEX-listed stocks are automatically admitted to this stream, in contrast to stocks listed on other marketplaces, which must be individually approved by each marketplace. *Id.* §§ VI(a), (d), (e).

511. *Id.* § IV(d).

512. The plan provides that any yearly revenues from the tape will first cover SIAC's operating costs. If there is any revenue remaining, during the first five years the NYSE will receive the first \$1.12 million from one data stream and the AMEX will receive the first \$200,000 from the other data stream. Any remaining revenue will be split among all SRO's, according to the proportion of transactions they reported. *Id.* §§ XI(a), (b). Therefore, if profits from the tape are less than \$1.32 million above costs, the NYSE and AMEX will receive all profits. The justification for this allocation is that partial reimbursement should be made for developmental costs. *Id.* These allocations could total about \$6 million over the five-year period. However, the total developmental cost for the central tape processor is estimated at \$1.5 million. Francis Palamara, Chairman of the CTA, Press Release at 1 (Aug. 1, 1974) (on file with the *Michigan Law Review*).

513. See generally THE CRISIS OF THE REGULATORY COMMISSIONS (P. MacAvoy ed. 1970). The CTA will have to find a comparable source of price data, select a proper rate of interest, and engage in debates concerning original versus replacement costs. See generally R. POSNER, *supra* note 213, at 142-49.

514. The books of SIAC will be audited by "a firm of independent public accountants (which may be the firm regularly employed by NYSE or the Processor)" CENTRAL TAPE PLAN, *supra* note 480, § XI(a)(iv). For a critique of such "independent" advice by outside professionals in another context, see Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1080 (1968).

515. See CENTRAL TAPE PLAN, *supra* note 480, §§ IV(d), (e).

516. See Green & Nader, *Economic Regulation vs. Competition: Uncle Sam the Monopoly Man*, 82 YALE L.J. 871, 880 (1973).

particular, the review procedures written into the central tape plan ensure the stability of SIAC's position. Before CTA can consider bids from any potential competitors, a majority of the board must vote that SIAC "has failed to perform its functions in a reasonably acceptable manner in accordance with the provisions of the Plan or that its reimbursable expenses have become excessive and are not justified on a cost basis."⁵¹⁷

b. *Regulatory arguments.* The SEC could argue that one entity should serve as tape processor and distributor because the consolidated tape is a natural monopoly. Average costs of a natural monopoly decline throughout the range of effective demand, so that a single firm can supply the entire output demanded at a lower cost than could several firms.⁵¹⁸ Such monopolies may occur when entrance into an industry requires a firm to expend large sums on fixed costs, although thereafter the marginal cost of producing any unit is minimal.⁵¹⁹ The only possible natural monopoly would be in the production rather than the distribution of the consolidated tape, however. After a firm incurred the fixed costs of collecting and sequencing last-sale data from all stock markets, the marginal cost of producing the tape for any one customer might be close to zero.⁵²⁰ If one firm were given a regulated monopoly in producing the tape and could divide production costs among all vendors, competition could still exist with respect to the distribution of the tape.⁵²¹

The SEC could also argue for one entity because everyone should rely on the same historical record of stock transactions.⁵²² Tapes with different sequences could cause confusion, for instance, in the valuation of securities at the time of death for estate purposes. But, to the extent that this regulatory argument is valid, it might be achieved by having one tape processor rather than one tape distributor.

Even if the case for giving some aspects of the tape production and distribution process entirely to one entity were persuasive, it would not justify the SEC's approval of SIAC without competitive

517. CENTRAL TAPE PLAN, *supra* note 480, § IV(d). Rejection of SIAC on any other grounds can be effected only through an amendment to the tape plan. *Id.* § IV(e). Since the owners of SIAC have veto power on amendments to the plan, *see* text at notes 509-10 *supra*, an amendment is unlikely to pass.

518. R. POSNER, *supra* note 213, at 139-41.

519. *Id.*

520. Note that the SEC has not made any empirical investigation of cost curves. *See* text at note 496 *supra*.

521. Vendors already compete with respect to display devices, the main fixed distribution cost. *See also* note 483 *supra*. While communication lines might be considered a fixed cost of tape distribution, these lines have already been built by the telephone company and can be leased at a standard tariff by any tape distributor.

522. Interviews, *supra* note 487.

bidding. The main defense of SIAC's preferential position is contained in the SEC's arguments for granting SIAC the exclusive right to sell continuous tape transmissions. The first argument is that SIAC would be the only reliable processor and distributor of the consolidated tape: The SEC feared that independent vendors would not have the incentive to provide the back-up capacity necessary to ensure that the ticker tapes will continue to run even if the primary system breaks down.⁵²³ However, the SEC could ensure that independent vendors include a back-up system by making it a specification in the competitive bidding process. It would then be possible to determine whether SIAC could run the tape with a back-up system less expensively than other firms. Furthermore, rather than inducing reliability by holding SIAC responsible for breakdown or error, the central tape plan indemnifies SIAC for "any liability, loss, claim, cost, damage or expense incurred or threatened as a result of the last sale price furnished to" SIAC and transmitted to tape users.⁵²⁴

The second argument is that SIAC would be more amenable to regulatory directives from the SEC than any private firm. "[A]s an exchange facility," the SEC has argued, SIAC is "directly subject to Commission oversight," while the "principal obligation of the independent vendors is to serve the interests of their shareholders rather than to promote fair and orderly markets and to protect investors."⁵²⁵ The exchanges obviously do not share this view of the SEC's authority: The NYSE and AMEX, for instance, have rejected the SEC's contention that it has the power to amend the central tape plan.⁵²⁶ On the other hand, the SEC itself has recognized that the proposed legislation would give it direct regulatory authority over stock market tape processors.⁵²⁷ Alternatively, the SEC could subject any tape monopolist to its authority by requiring certain contract provisions in the bidding specifications. Either method would probably give the Commission more regulatory authority over the tape monopolist than it now has over SIAC.

523. "Currently, the exchanges provide extensive back-up systems for their tapes to ensure these tapes will continue to run even if there is a breakdown in the primary system. It is not clear that the interest of the independent vendors in uninterrupted service would be sufficiently great to justify the expense involved in developing such a back-up capability." SEC Securities Exchange Act Release No. 10671, *supra* note 479, at 83,879.

524. CENTRAL TAPE PLAN, *supra* note 480, § IV(c).

525. SEC Securities Exchange Act Release No. 10671, *supra* note 479, at 83,879.

526. *See id.* at 83,876; Letter from James Needham, Chairman of the NYSE, to Raymond Garrett, Chairman of the SEC, Aug. 10, 1973, at 13-14.

527. *See* SEC Securities and Exchange Act Release No. 10671, *supra* note 479, at 83,879; S. 249, 94th Cong., 1st Sess. § 6 (1975).

The SEC's final argument is that SIAC should run the tape monopoly because since 1968 the NYSE has charged uniform rates for ticker services regardless of actual cost differences among geographic locations.⁵²⁸ In contrast, private firms might "find it more profitable to concentrate their efforts in high-volume metropolitan centers and either discontinue service to more remote areas or charge a fee more commensurate with the costs involved in providing such service."⁵²⁹ The SEC's rule 17a-15, however, does not prohibit SIAC from charging differential rates, although it permits SIAC to require all private vendors to charge uniform rates.⁵³⁰ Under this rule, it is possible that SIAC would revert to the NYSE's pre-1968 policy of price differences for the tape service and that private vendors would be forced to sell interrogation services at geographically uniform prices.⁵³¹ In addition, the technological basis for the SEC's argument on uniform pricing is rapidly becoming obsolete. While the traditional system of sending the ticker tape via Western Union lines has varying costs among regions, advances in multi-packet switching are starting to eliminate price differences based on geographical location.⁵³²

Thus, the efficiency losses and administrative problems imposed by the central tape plan may decisively outweigh its regulatory benefits. Even viewed as a close case, the plan could be invalidated under the revised *Silver* test. The SEC has no specific guidelines from Congress on the organization of the tape,⁵³³ and the structure of the CTA does not permit easy correction of erroneous judicial approval⁵³⁴ in an area of rapidly changing technology. By invalidating the plan, the court would force the SEC to revamp the consolidated tape proposal along more competitive lines, under the procedural protections of the new test.

528. See SEC Securities Exchange Act Release No. 10671, *supra* note 479, at 83,879.

529. *Id.*

530. 17 C.F.R. § 240.17a-15(f) (1974).

531. Before 1952, Western Union handled the tape for the NYSE and charged differential rates based on costs. Between 1952 and 1968, the NYSE ran its own service and rented lines from Western Union. The NYSE divided the nation into zones according to distance from New York City and charged a different rate for each zone. See Letter from the NYSE and AMEX to the SEC, June 1, 1973.

532. The FCC has recently approved the application of Telenet, Inc., to provide terminal-computer and computer-computer communications utilizing packet-switching. See In the Matter of the Application of Telenet Communications Corporation, File No. P-C-8780 (April 16, 1974). Telenet charges per packet of information, irrespective of distance traveled or location. Telenet, Public Packet Switching Networks 11-12 (March 8, 1974).

533. See generally Securities Exchange Act of 1934, § 19(b)(8); 15 U.S.C. § 78s(b)(8) (1970); text at notes 309-11 *supra*.

534. See generally text at note 313.

IV. CONCLUSION

This article has presented an alternative to the current jurisdictional approach to resolving the tension between competition and regulation in the securities industry. Under the jurisdictional approach, the court hides substantive issues behind a facade of forum selection. Under the revised *Silver* test, the court would deal explicitly with the economic issues raised by restrictions on stock transactions. Under the jurisdictional approach, the court chooses between one procedure favoring competition and another favoring regulation. Under the revised *Silver* test, the court would follow only one procedure that permits opposing parties to present findings on roughly equal footing. Under the jurisdictional approach, the court must award either injunctive relief against the SEC or treble damages against an SRO for harms already imposed by regulatory restrictions. Under the revised *Silver* test, the court would determine the validity of such restrictions before they give rise to claims for money damages.

While this alternative was developed for the securities industry, it may be relevant in other areas. The tension between competition and regulation has become a matter of great concern in most regulated industries,⁵³⁵ yet the general line of precedents under the doctrine of primary jurisdiction is confused.⁵³⁶ By examining the impact on competition of governmental intervention in each regulated industry, it would be possible to delineate the relevant categories of empirical data under a decisional rule analogous to the revised *Silver* test.⁵³⁷ Appropriate presumptions against certain types of regulatory restrictions could be established, such as the presumption against SEC regulations geared to distributional concerns.⁵³⁸ Disputes could then be resolved in one forum in which the agency with a bureaucratic interest in the particular industry would battle the Justice Department as the advocate of competition for the entire economy.⁵³⁹

535. See generally *THE CRISIS OF THE REGULATORY COMMISSIONS*, *supra* note 513. Legislative proposals have recently been made to establish an independent commission to study reforms of agencies that regulate private industries. See BNA SEC. REG. & L. REP. No. 279, at A-7 (Nov. 27, 1974).

536. See note 29 *supra*.

537. According to Thomas Kauper, Assistant Attorney General for Antitrust, the Antitrust Division has begun such an analysis of the anticompetitive effects of various agency actions. See BNA SEC. REG. & L. REP. No. 279, at A-9 (Nov. 27, 1974).

538. See text at notes 252-69 *supra*.

539. See, for example, the recent battle between the CAB and the Justice Department over minimum rates for chartered flights, as illustrated in Comments and Alternative Motion for Hearing of the United States Department of Justice on Proposed Regulation 14 C.F.R. § 399.45, CAB Docket No. 25875 (Nov. 2, 1973); CAB, Statement of General Policy: Minimum Charter Rate Level, Order 74-12-40, CAB Docket No. 25875 (Dec. 11, 1974) (denying Justice Department's motion for stay and dismissing its petition).